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ABSTRACT

This is a thoroughly revised edition of the 1969 publication, "Accounting for Independent Schools," a guide that attempted to codify basic accounting principles and practices for specific application to independent schools. The focus of the second edition is more on refining practices than on initiating them, and more on extending the managerial uses of accounting information than on defining them. However, the basic objectives that guided the preparation of the first edition apply as well to the second. This edition offers school officials and accountants systematic guidelines to "best" current accounting, reporting, management, and planning practices. Separate chapters focus in turn on basic accounting principles, the chart of accounts, sample journal entries, financial statements, dealing with independent certified public accountants, basic accounting systems, automating accounting systems, budgeting, cash management, and financial planning. (Author/JG)

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ACCOUNTING FOR INDEPENDENT SCHOOLS

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Second Edition

April 1977

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Foreword

Accounting for Independent Schools was first published by the National Association of Independent Schools in 1969 in response to a growing request for guidelines in accounting for new as well as established schools. Until that time, although there were many accounting books for other kinds of institutions, there had been no accounting guide specifically directed to the independent school. The response to the original edition was gratifying, and the evidence is that the great majority of NAIS member schools subsequently modeled their accounting procedures in whole or in part on the recommended guidelines. The book has provided a useful tool for more efficient operation of schools, and the widespread adoption of its methods has greatly facilitated the making of valid comparisons between schools of operating income and expense items.

The changes and advances that have taken place in school accounting since 1969 called for a substantial revision of the original text when the time came for a new edition. The NAIS Business Affairs Committee has had such a revision as a major item on its agenda for the last two years. This second edition of Accounting for Independent Schools is the result of the committee's work.

The committee appointed John Shank, former associate professor of business administration at the Harvard Graduate School of Business Administration, to revise the book. Professor Shank, a certified public accountant, has served as director of a series of financial workshops for NAIS and as a member of the faculty, in the field of financial management, of the NAIS Institute for Administrative Leadership. Mr. Shank

has also served as a trustee and treasurer of an independent school. He is presently Arthur Young Distinguished Professor of Accounting at Ohio State University.

Collaborating with Professor Shank was an ad hoc subcommittee of school fiscal officers consisting of Helen L. Diserens, business manager, Rippowam-Cisqua School (N.Y.), chairman; Anthony B. Fruhauf, director of financial affairs, University-Liggett School (Mich.); George A. Neilson, Jr., business manager, Phillips Academy (Mass.); Robert C. Barber, business manager, Choate Rosemary Hall (Conn.); and William Barrett, director of administrative services, Gill/St. Bernard's School (N.J.). With the exception of Mr. Barber, all are members of the NAIS Business Affairs Committee. Remaining members of the Business Affairs Committee, which had ultimate responsibility for the project, are William Martin, assistant headmaster for finance and development, New Canaan Country School (Conn.), chairman of the Business Affairs Committee, and Richard Everett, III, business manager, Groton School (Mass.).

To Professor Shank and all of the committee members goes our warm appreciation for their dedicated service.

A first draft of the manuscript was sent for comment to over 100 people in schools, accounting firms, and others interested in independent education, and a large number of suggestions and criticisms was received from them. Professor Shank and the ad hoc committee reviewed all of the comments received and adopted many of the suggestions. We are grateful to all those who assisted in this review.

And we are grateful, too, to Abbott Wainwright, editor of the Administrative Service of the National Association of College and University Business Officers (NACUBO), for the interest and effort he contributed

to the publication, and to NACUBO itself for permission to quote portions of College and University Business Administration.

We are especially indebted to the following business organizations for their generous help in providing a substantial portion of the funds for the project: Chemical Bank, Ernst & Ernst, Manufacturers Hanover Trust Company, Morgan Guaranty Trust Company of New York Charitable Trust, Olivetti Corporation of America, and T. Rowe Price Associates, Inc.

Cary Potter
President, NAIS

April 1977

Preface

When Accounting for Independent Schools was published in 1969, it represented a first attempt to codify basic accounting principles and practices for specific application to independent schools. Four objectives were specified for the book.

- To develop uniform accounting and financial reporting procedures that are generally compatible with the financial activities and organizational structures of independent schools and to provide a framework for the use of proper accounting procedures in all independent schools.
- To enable independent schools to prepare financial statements that accurately reflect the financial position of the school and the results of its operations.
- To develop guidelines for uniform terminology and account classification for revenues and expenses to facilitate, over time, comparisons within a school and among schools and to contribute to a fuller understanding of the uses--and the limitations--of such comparisons.
- To help school administrators carry out their financial management and fiscal stewardship responsibilities by enabling them to develop comprehensive, relevant, management-oriented accounting data.

Accounting for Independent Schools has served well on all four counts.

When published, it represented a significant milestone, both in starting to establish "good accounting practice" for independent schools, and in establishing NAIS as a legitimate source of information and authority in this area. We believe it is fair to say that the book has been accepted as authoritative throughout the NAIS membership.

Because of material progress since 1969 in many aspects of school

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accounting and reporting, NAIS considered it appropriate to revise the book so that it could continue to be authoritative over the next several years. While the changes reflected in this edition are much more evolutionary than revolutionary in character, we felt that they were important enough to warrant a thorough reworking of the 1969 edition.

The 1969 book represented "best" current practices. Its suggestions were a few steps ahead of what most independent schools were doing then. The book could and did serve as a model to which all schools could aspire. In 1977, that book no longer reflects the cutting edge of best accounting practice. Rather, it codifies minimum acceptable practice. Most schools have caught up to the earlier edition, and many have gone beyond it in some key areas. In preparing this second edition, we want to put Accounting for Independent Schools out in front again, particularly with respect to understandable financial reporting and managerial uses of accounting data.

The same four objectives that guided the preparation of the first edition are reaffirmed here. The focus now is more on refining practices than on initiating them, and more on extending the managerial uses of accounting information than on defining them. The basic objectives themselves have not changed.

We believe this second edition is relevant for all independent schools. We hope those schools who feel that this manual goes beyond their needs or capacities will view it as an attempt to upgrade the general level of school accounting and think carefully about just how adequate to their needs their existing practices really still are. Schools whose size and resources permit more sophisticated accounting and reporting systems will probably find little that is new. Nevertheless, we

hope they will continue to help pioneer new developments in school accounting and assure themselves that their practices are consistent with the general principles of this book.

The first edition codified good practice while encouraging continued improvement in accounting and reporting as conditions changed. Just as it was a working document, so is this edition. It prescribes without proscribing further progress. As conditions continue to change and new points of view evolve, we hope all NAIS member schools will work with NAIS to continue this process of updating and refining generally accepted accounting principles for independent schools.

Chapter 1

BASIC ACCOUNTING PRINCIPLES FOR INDEPENDENT SCHOOLS

Accounting in independent schools, as in all educational institutions, has two objectives: (1) to fulfill the obligation of financial stewardship and accountability for the funds entrusted to the school, and (2) to disclose as fully and understandably as possible the results of operations and the financial position of the school. The accounting principles described here are intended to help achieve these objectives.

In this chapter, we have drawn heavily on the provisions of the industry audit guide, Audits of Colleges and Universities, published in 1973 by the American Institute of Certified Public Accountants and amended in 1974, as well as on the third edition (1974) of College and University Business Administration, which is endorsed by the National Association of College and University Business Officers. While our manual differs from those publications in some respects, everything proposed here is fully in accordance with generally accepted accounting principles. We differ only where we feel that other authoritative sources do not sufficiently incorporate recent progress in making school accounting as understandable and managerially useful as possible. There is actual precedent among independent schools for the recommendations made here, as well as support from more than one of the major international public accounting firms.

I. Accounting Principles

A. The General Ledger

A double-entry system of accounting should be used by every school. Single-entry systems, which consist only of cash receipts and cash disburse-

ment registers, do not contain enough information to prove that the school is meeting its stewardship responsibility for the funds it receives. Furthermore, single-entry systems lack the internal control needed to ensure that all transactions and accounting adjustments will be recorded properly.

By using a double-entry system, the school can provide adequately for the recording of assets, liabilities, fund balances, revenues and other fund additions, expenses and other fund deductions, and interfund transfers, all in balanced fund groups (see section C.2, p. 4).

The general ledger of the school should contain account groupings for all the funds over which the school has control and/or from which it is entitled to disburse.

B. Accrual Accounting

In order to provide adequate information about school operations and thus foster effective administrative control, accounting records should be maintained on an accrual rather than on a cash basis. This means that the accounts reflect all significant amounts receivable and payable and revenues earned and costs incurred (even though cash may not yet have been received or disbursed).

If items are not recorded until cash is received or disbursed, it is difficult and sometimes impossible to make accurate summaries of the operating results of individual fiscal periods. For example, it is hard to measure the current year's tuition revenue when the cash basis is used, since cash receipts during the year include some of this year's tuition, some of last year's (late collections), and some of next year's (advance deposits). Furthermore, some of this year's tuition will not

be collected until next year. Accrual accounting eliminates this kind of problem.

Depending on the size and capacity of the school's accounting office, accrual accounting can be achieved in one of two ways: (1) all revenues and costs are accrued daily in the books of account as part of the normal operations of the accounting system, with revenues and receivables recorded when earned, and expenditures and payables recorded as the related services or materials are received, or (2) all transactions (with the possible exception of student billings) are recorded only when cash is received or disbursed, with significant noncash amounts accrued at the end of each fiscal period by making special adjusting journal entries.

If significant month-to-month fluctuations in the school's cash position are typical, it may be desirable to make accrual adjustments at the end of each month to ensure meaningful monthly financial statements. Whether or not accrual adjustments are formally recorded more than once a year, care should be taken, in preparing interim financial statements, that results are fairly presented on an accrual basis.

The second method above is easier to administer on a day-to-day basis. We believe that this approach will almost always prove more efficient for independent schools.

C. Fund Accounting

In order for schools to account best for the diverse resources made available to them and the diverse uses to which those resources are put, we believe that they should follow the principles of fund accounting.

1. Definition

Fund accounting is the procedure by which economic resources

and obligations are segregated into separate account groupings according to the function or purpose the resources serve. Limitations on the use of monies or assets are of two kinds: restrictions and designations. Restrictions can either be imposed by donors or other external agents, or they can arise from regulations. Designations, made by the board of trustees, can be removed or changed at the board's direction. Fund accounting is a well-established concept that ensures that the school is fully carrying out its stewardship responsibility for all the resources entrusted to it.

2. Basic Procedures

Each fund is a separate entity comprised of a balanced set of accounts. The asset accounts of a fund reflect the economic resources committed to the fund. The liability accounts of a fund reflect the economic obligations owed by the fund. The fund balance account reflects the net difference between the total assets and total liabilities of the fund. The accounts of a fund are thus in balance at all times: $\text{Assets} - \text{Liabilities} = \text{Fund Balance}$. In a statement of the financial position of a fund, this relationship is usually shown as: $\text{Assets} = \text{Liabilities} + \text{Fund Balance}$.

All financial transactions involving revenues and other fund additions or expenses and other fund deductions are always recorded within a specific single fund, thus preserving the principles of double-entry bookkeeping for each fund for each transaction. Financial reports also should fully reflect the fund groupings that exist in the books of account.

3. Recommended Fund Categories

For most independent schools, three major fund categories are sufficient: operating funds, endowment funds, and plant funds. The term "operating funds" is preferable to "current funds" or "general funds" because it better conveys the purpose of such funds. If the amounts committed for any of these three purposes are significant, we recommend that a separate fund or group of funds be established rather than including the amounts within one of the other major categories.

Some schools include plant assets in the operating fund on the premise that plant assets are used for operations and are often purchased with unrestricted operating funds. Even if restricted funds are used, they argue that the restriction has been discharged once the plant assets are purchased. Because we believe that it is more appropriate to set up plant assets and any related liabilities in a separate fund to reflect the distinct, separate purpose served by such assets, we recommend that plant assets not be merged with operating assets. But, if plant assets are merged into the operating fund, it is very important to show separate fund balance subtotals for operations and for net investment in plant. Merging fund balances and assets conceals an essential distinction: the net resources available for operations versus the net investment in plant. These two amounts should be shown separately.

Within each of the three major categories, a further two-way breakdown is recommended if the amounts involved are material. Under operating funds, restricted funds should be distinguished from unrestricted funds, where "restricted" is used in the strict sense of donor stipulations. Under endowment funds, like operating funds, the distinction is the same: unrestricted funds and restricted funds. Under plant funds,

the breakdown is between unexpended and expended amounts. Unexpended plant funds are cash or securities set aside for purchase of plant assets or retirement of plant-related debt; expended plant funds represent cumulative net investment in plant assets.

Classifying plant assets as "endowment" or "operating" depends on whether the school considers the resources themselves available for use or only the income those resources earn. If only the income is available for use, either by restriction or designation, assets should be classified as endowment funds. If the assets themselves may be expended, they should be classified as operating funds.

Thus, where significant amounts are involved, we recommend that the following three two-part fund categories be maintained separately in the books of account.

Operating Funds

Unrestricted: Economic resources available for any purpose to carry out the objectives of the school

Restricted: Economic resources restricted to specific operating expenses

Endowment Funds

Unrestricted: Economic resources invested to produce income that may be used for any purpose to carry out the objectives of the school

Restricted: Economic resources invested to produce income that may be used only for specified purposes

Plant Fund

Unexpended: Liquid resources set aside for future investment in plant assets or retirement of plant-related debt

Expended: Plant assets (land, buildings, equipment) of the school and any related liabilities

We also recommend that these categories be reflected separately in the financial statements of the school, but with no further breakdown.

4. Further Fund Distinctions

a. Endowment Funds

For some schools, a further breakdown of endowment funds may be desirable. If the trustees of the school deem it appropriate, the following separate fund groupings may be maintained.

Pure Endowment

Unrestricted: The donor specifies that the principal may not be expended. The income may be used for any purpose the trustees deem appropriate.

Restricted: The donor specifies that the principal may not be expended. The income may only be used for the purposes specified by the donor.

Quasi-Endowment

Unrestricted: Unrestricted assets of the school are designated for investment by the board of trustees. The principal may only be expended when authorized by the board. Income (and principal, when authorized) may be used for any purpose the trustees deem appropriate.

Restricted: Donor-restricted assets of the school are designated for investment by the board of trustees. The principal may only be expended for the donor-restricted purposes when authorized by the board. The income (and principal, when authorized) may be used only for the purposes specified by the donor.

Term Endowment

Term endowment funds are those from outside sources for which the donor has stipulated that the principal is expendable upon the happening of a certain event or after the passage of a stated period of time. Term

endowment is usually restricted, but it might also be unrestricted. If significant amounts of both kinds of funds exist, two separate categories would be appropriate.

If these endowment fund groups are reflected separately in the school's books of account, and if the amounts involved are sizable, we recommend a footnote to the financial statements to show the separate fund balances (pure, quasi-, and term) making up the two overall fund balances that are reflected in the statement of financial position for restricted and unrestricted endowment.

b. Unexpended Plant Funds

Some schools may wish to break down unexpended plant funds into the following categories.

Funds accumulated for addition to plant and equipment

Funds accumulated for retirement of indebtedness on school property

Funds accumulated for replacement or renewal of plant assets

If such a breakdown is maintained, and if the amounts involved are sizable, we recommend a footnote to the financial statements showing the separate fund balances that make up the overall fund balance for unexpended plant funds.

5. Miscellaneous Fund Categories

The following fund categories, which do not exist in many schools, usually involve insignificant amounts. If they do exist, the following accounting principles should be applied.

a. Loan Funds

This category is used to account for monies set aside to make loans to students, faculty, and/or staff. If only the income of the fund may be loaned, the principal should be included under restricted endowment funds, and only the income be shown in the loan fund group.

Loans granted are a receivable of the particular loan fund from which they were made and should not be recorded as a reduction of that fund's balance. Loan repayments should be applied to the receivable, not to the income, of the fund. Similarly, any interest received is income of the loan fund. If a loan turns out to be uncollectable, it should be written off as a corresponding reduction in the appropriate fund balance.

If it seems desirable or informative, a description of the composition of the loan funds and/or the composition of the loan portfolio may be given in a footnote to the financial statements.

If loan funds are not substantial, they may, for financial reporting purposes, be included under the restricted operating fund.

b. Annuity and Life Income Funds

This category is used for funds acquired by the school that carry the obligation to distribute either a fixed income (annuity) or a variable income (life income) to the donor or other designated individuals during his or their lifetime. Once this obligation is fulfilled, these funds should be transferred either to operating, endowment, or plant funds as is appropriate.

If annuity or life income funds are not substantial, they may, for financial reporting purposes, be included under endowment funds.

This category does not include annuities purchased or owned by the

school for the benefit of active or retired employees. Such annuities should be classified under endowment funds. Similarly, this section does not apply to recipients who are current or former employees. Because annuities and/or life income funds for the benefit of such employees may be subject to the Employee Retirement Income Security Act of 1974 (ERISA), schools should seek advice of counsel before setting up either type of fund out of gifts or other monies.

c. Agency Funds

This category is used to account for funds for which the school is custodian and makes disbursements in accordance with instructions of the person or organization from whom it received the funds. Receipts and disbursements of agency funds should be recorded separately, not as part of the operating funds of the school.

For financial reporting purposes, agency funds should be included under accounts payable of the unrestricted operating fund. Since these funds do not belong to the school, any unexpended balance should be presented separately from the fund balances for school-owned funds. If agency funds are not substantial, the balance may, for accounting as well as financial reporting purposes, be included under accounts payable of the unrestricted operating fund. If agency funds are significant, amounts should be disclosed in a footnote.

d. "Miscellaneous Funds" as a Specific Category

If the amounts of loan funds or annuity and life income funds are material, they may be shown separately in the financial statements. If both categories are material, they may be combined in one category labeled "miscellaneous funds" for purposes of preparing

financial statements for the school. The composition of the combined fund balance should then be shown in a footnote.

II. Financial Reporting Principles

A. Annual Financial Report

A comprehensive financial report should be prepared once a year for submission to the board of trustees and others authorized to receive it. This report should include

A comparative statement of financial position (commonly called a "balance sheet")

A comparative statement of revenues, expenses, and other changes in fund balances

Footnotes to these two financial statements giving whatever additional information is needed to make the presentation fully informative

An opinion on the financial statements by an independent certified public accountant

We also recommend that the annual financial report include separate schedules supporting the financial statements (see examples in Chapter 4), as follows.

If there are endowment funds, a summary of the composition of investments, a recapitulation of investment income (see Exhibit 4-4, p. 85), and, if desired, a detailed listing of all endowment funds

If significant amounts of gifts or bequests are received, a summary breakdown of sources of gifts and uses to which these gifts are put (see Exhibit 4-5, p. 86), with a detailed listing of gifts, if desired

If amounts are significant, a summary of interfund borrowings (see Exhibit 4-6, p. 87)

Operating expenses, broken down by function and by object of expenditure (see Exhibit 4-7, p. 88)

Some schools also include a statement of changes in financial position in their annual financial report. This statement is commonly called "sources and uses of funds" or "funds flow." Inclusion of such a statement in the annual reports of commercial enterprises has been required since 1971. Because it is not required of colleges and universities, we do not believe that such a statement should be required of independent schools, either. Nearly all the information such a statement presents is already reflected clearly in the statement of revenues, expenses, and other changes in fund balances. And, because a statement of changes in financial position provides much less information for an educational institution than it does for a commercial enterprise, we do not recommend its inclusion in the annual financial report.

B. Statement of Financial Position

The statement of financial position (commonly called the "balance sheet") reflects the assets, liabilities, and fund balance for each fund grouping within the school. It summarizes the financial position of each fund at the end of the fiscal year. It is important that the overall financial position of the school be reflected in this statement as well. While it is true that each fund is an entity that should be reported separately, it is also true that the primary entity that interests readers of the financial statements is the school as a whole. The columnar format shown in Chapter 4 is recommended because it best meets these dual objectives. Comparative totals for two years, as illustrated in Chapter 4, should also be presented wherever possible.

C. Statement of Revenues, Expenses, and Other Changes in Fund Balances

Our recommendation for combining the statement of the operating

fund and the statement of changes in fund balances into one statement represents a major departure from the earlier NAIS accounting manual. No information is lost when the two statements are combined. On the contrary, much new information is gained about the overall operating results of the school.

Under the earlier approach, the statement of operating funds (or "general funds," as they often used to be called) reflected those operating revenues and expenses of the school for the year that were recorded under operating funds. It also reflected any nonoperating additions to or deductions from operating funds during the year.

The distinction between operating and nonoperating items was not carefully drawn because the statement was a summary of all activity in the operating funds during the year. The fact that such funds were used primarily to record operating items did not mean that only operating items were included. In fact, significant nonoperating items were usually included.

Under the earlier approach, the statement of changes in fund balances summarized all additions and deductions during the year for each of the various fund groupings of the school. Changes in the operating funds were shown in highly summarized form because the activity in these funds was shown in much more detail in the separate statement of operating funds.

No attempt was made in the statement of changes in fund balances to maintain a distinction between operating and nonoperating items because all additions to and deductions from the various fund groupings were being presented. The fact that these fund groupings were used primarily to record nonoperating items did not mean that only such items were

included. In fact, significant operating items were often included here, rather than in the statement of operating funds.

Under the new, recommended combined report, which uses a columnar format, all activity in each fund grouping is still presented for that grouping. That is, the principle of showing separate fund groups separately is maintained here. Each column of the report details all the activity during the year in a particular fund grouping and reconciles the over-all change during the year in the fund balance account. A "total" column combines the activity for all the fund groupings.

Each column shows operating items at the top and nonoperating items at the bottom. Thus, the operating items in all funds can be summarized by adding together the top portions of each of the columns. The over-all operating results for the school can be seen in the top portion of the "total" column of the statement.

The major reason for combining the statement of operating funds and the statement of changes in fund balances is to show overall school operating results more easily without violating the concept of fund reporting as a corollary of fund accounting.

Traditionally, it has been argued that the concept of an operating surplus or deficit has no significance in a school because it is not the function of a school to generate a surplus. We believe, however, that independent schools, like all organizations, can only survive in the long run if revenues and other additions equal or exceed expenses.

Failure to focus on the overall operating surplus or deficit ignores the most important single indicator of financial health for the school.

This is not to say that deficits are always bad or that surpluses are good. Rather, it means that the concept of looking at operating inflows

and outflows together and measuring the net difference is a useful tool for assessing the school's total operating performance.

It has also been argued traditionally that adding fund groupings together is misleading because it violates the principle that each fund is a separate entity. If only a "total" column were shown, this argument would have considerable weight. However, when each fund grouping is shown both separately and in a set of combined totals, the additional information conveyed about the school as a whole outweighs the possibility of misleading the reader.

While there are good logical and technical reasons for the evolution of independent schools' financial statements in the forms typically seen up to now, we believe that it is time to reorganize them, as recommended here, so that they can best communicate the message they are intended to convey. Chapter 4 illustrates the recommended reporting formats.

D. Consolidated Affiliated Entities

The financial statements of any development fund, foundation, summer camp, or similar organization that is integrally affiliated with, associated with, or controlled by the school and that operates under section 501(c)(3) of the Internal Revenue Code should be consolidated with the financial statements of the school. Also to be included are endowment funds held by a separate foundation whose function it is to generate income for use by the school as well as any separate organization that owns all or part of the plant assets used by the school. Not included is a foundation that holds investments or property for the benefit of several different schools or nonprofit organizations, or any charitable remainder trust, which should not be accounted for until funds are received.

We recommend that separate entities not be established to hold investments or property that are for the benefit of only one school. To create separate foundations fragments the administration of the school, creates the problem of overlapping boards, and raises the prospect of disagreement between boards with no convenient way of arbitrating disputes.

E. Footnotes to Financial Statements in the Financial Report

Footnotes are a convenient device for extending the amount of information disclosed in the financial report without unduly complicating or extending the financial statements themselves. Footnotes should be considered an integral part of the financial statements. A footnote should be added wherever the financial statements themselves do not give enough information to show the significance of an item to the overall financial situation.

Footnotes typically include

Accounting policies followed in areas where amounts
are sizable and accounting options are available

Details of any pension plans, including annual pension
expense

Details of any long-term indebtedness

The existence and maturity schedule of any large
pledges receivable

The existence of any known charitable remainder trusts

F. Independent Auditor's Opinion

We recommend that every annual financial report of the school include the opinion of a certified public accountant that the financial statements fairly present the financial position of the school and the

results of its operations, in conformity with generally accepted accounting principles for independent schools.

An annual audit of the school's accounts by an independent certified public accountant is an essential control for helping the trustees to fulfill their fiduciary responsibilities. This subject is discussed in more detail in Chapter 5.

G. Supporting Schedules to the Financial Statements

We believe that the information meriting supplementary disclosure in the annual financial report (see section A, pp. 11-12) is important enough in assessing the overall financial situation of the school that it warrants creating separate schedules to accompany the basic financial statements.

We therefore recommend that the four schedules mentioned at the bottom of page 11 each be presented as a separate footnote to the financial statements so that the information they contain will be covered by the auditor's opinion. If this doesn't seem feasible, for whatever reason, these schedules should be presented as addenda to the financial statements, with a statement by the school's treasurer that the information is presented fairly.

Examples of the recommended format for each of these four schedules are shown in Chapter 4.

III. Valuation of Assets

A. Definition of Assets

Assets are the tangible resources having monetary value that are owned by the school. Unless otherwise specified in this manual, valuation of assets should follow principles generally accepted for commercial enterprises.

B. Plant Assets

1. Definition

Plant assets are land, buildings, leasehold improvements, land improvements, and equipment. "Equipment" includes vehicles, furniture, and library books, as well as other equipment used in school operations. A piece of equipment is defined as being a material unit that meets all of the following conditions.

It retains its original shape and appearance with use.

It is nonexpendable; that is, if the article is damaged or some of its parts are lost or worn out, it is usually possible to repair it instead of replacing it with an entirely new unit (which is not true of supplies).

It represents an investment of money, which makes it possible and advisable to capitalize the item.

It does not lose its identity through incorporation into a different or more complex unit or substance.

We recommend that the school set a minimum dollar figure on each piece of equipment (many schools use \$100 as a reasonable cut-off figure) so that expenditures below that amount can be expensed directly and not capitalized in the plant accounts.

2. Accounting Procedures

Accounting, or bookkeeping, for categories of plant assets varies with the type of asset, as outlined below.

a. Buildings, Land Improvements, Major Leasehold Improvements

These kinds of assets are not renewable but are replaced when they wear out. They should be reflected in the books at their original acquisition cost or, in the case of donated assets, at estimated fair value

at the date of receipt of the gift. These assets should continue to be carried on the books at their original cost until they are retired from use, at which time they should be removed from the books. Replacements and/or additions to the asset base should be treated as capital expenditures rather than as operating expenses.

b. Library Books, Instructional Support Equipment, Athletic Equipment

These are plant assets for which annual expenditures for expansion or replacement can be budgeted in fairly regular amounts. These assets should be reflected in the books at acquisition cost (or at estimated fair value, for donated assets). This original acquisition amount should be left in the accounts indefinitely, because annual expenditures for replacement and/or expansion should be considered an operating expense of the school. Since the annual expenditure rate is presumed to be fairly regular, this approach approximates charging each year's operating budget with one year's portion of the wearing out of the assets. Thus, the asset accounts continue to reflect the approximate original cost of the asset base being used in the school's operations.

If in any one year a part of the year's expenditure represents expansion of the asset base rather than replacement, this part may be capitalized as an addition to plant assets.

c. Vehicles, Major Academic Support Systems (Language Lab, Computer, etc.), Office Equipment, Building Components (Heating Systems, Plumbing Systems, Roofs)

These are plant assets for which replacement or renewal expenditures tend not to occur in regular annual increments but which

represent significant amounts when they do occur. Accounting for the original acquisition and eventual retirement of such items should follow the same approach outlined for buildings, land improvements, and major leasehold improvements in section a (pp. 18-19). Accounting for expenditures to renew or replace this category of items should follow the procedures explained in section VI.B (pp. 35-38), "Provisions for Plant Replacement, Renewal, and Special Maintenance."

3. Income-Producing Plant Assets

Plant assets that are not used for school purposes but are held, instead, to produce income for the school represent a form of endowment. Such assets should be recorded under endowment funds, and the income should be considered as investment income. Houses, apartments, or other real property managed for the purpose of generating income are included here. Not included are houses or apartments normally occupied by faculty or staff members, since they represent assets used for "school purposes."

4. Depreciation

Although plant assets should continue to be recorded at original cost following their acquisition, we do not recommend that they be shown net of accumulated depreciation because the figure generated by subtracting accumulated depreciation from historical, or original, cost is not useful enough to warrant the revision of the school's accounting procedures that is needed to produce it.

As of mid-1976, there was considerable turmoil in the accounting profession about the proper basis for valuation of property assets. Many people favored the "replacement value" approach. Others favored using

"estimated sale value." Still others preferred "historical cost adjusted for changes in general purchasing power since acquisition." Until the accounting profession can reach a consensus on valuation and recording of plant assets, we recommend that current practice be followed, without any interim changes. Thus, while we recommend that plant assets be recorded as outlined above, we do not think that they should be depreciated.

The last part of our recommendation notwithstanding, it is still considered acceptable practice to depreciate plant assets, as some schools do. If and when depreciation is recorded, the annual increase in accumulated depreciation should reflect the cost of each of the assets (or market value at date of acquisition, for donated assets) divided by the number of years of estimated useful life. This kind of depreciation accounting--simply a way of showing that these assets will be used up, over time--is not intended to reflect a valuation process or to create funds for replacing the assets. Furthermore, the amount of annual depreciation is not an expense item of the school. Section VI (pp. 35-39) considers a separate subject: how best to allow for the expense related to use of plant assets in the operating funds. To show plant assets in the balance sheet net of accumulated depreciation is intended only to reflect the fact that, except for land, such assets do have limited life and do wear out eventually. If plant assets are depreciated, both cost and accumulated depreciation should be clearly disclosed in the financial statements.

C. Investments

1. Securities

Investment securities should be recorded at cost when they are acquired. Securities donated to the school for investment purposes

should be recorded at their estimated fair market value as of the date the gift is received.

If fixed-return securities (bonds or notes) are acquired at a discount or premium, the discount or premium should be amortized as income until they mature. "Straight line" amortization is permissible when the results are not significantly different from those achieved under the conceptually sound but more cumbersome "compound interest" amortization approach (the method of computing interest that is used in bond tables and by banks in drawing up mortgage repayment schedules).

After acquiring investment securities, schools and colleges have traditionally valued them at cost--a method that tends to be conservative and avoids recognizing fluctuating amounts of unrealized gains and losses that result from temporary swings in market prices. Furthermore, estimates of market value may be subjective. The cost method has also been the generally accepted way of valuing securities in most commercial enterprises over the years.

In recent years, educational institutions have moved toward valuing investment securities at market value, which more accurately reflects current financial position and provides a better basis for measuring investment performance from year to year. This "market method" of valuing securities has been generally accepted in investment companies and mutual funds for many years. Incidentally, when independent school endowment portfolios are compared for size, they are almost always shown at estimated fair market value.

Accounting principles for commercial firms were changed in 1976 to disallow completely the cost method of valuing equity securities. Firms not using the market method are now required to use the "lower of

cost or market" method. Here, the aggregate market value of all equity securities held as of the balance sheet date is compared to the aggregate cost of the securities, with the balance sheet reflecting the lesser of the two amounts. The lower of cost or market method is even more conservative than the cost method, since it allows for all possible losses but does not anticipate any unrealized gains.

Because there was no clear-cut mandate for or against any one of these methods in educational institutions as of mid-1976, we do not recommend any one method. While we tend to prefer the market method, we see no compelling reason to rule out either the cost method or the lower of cost or market method at this time. The illustrative financial statements in Chapter 4 use the market method. Whichever method the school adopts should be used consistently from year to year. In any event, both the cost and the market value of the investment portfolio should be clearly disclosed in the financial report.

If either the market method or the lower of cost or market method is used, unrealized adjustments to the carrying value of the portfolio should be recorded in a separate fund balance account. Changes in the net balance each year should be reported as nonoperating additions to or reductions in this separate fund balance.

Separate fund balance accounts should also be maintained for the principal sum of investments and for undistributed investment income.

Endowment funds and investment securities owned by other funds may be pooled for investment purposes if permitted by statute and by the terms of the instrument of gift. If securities are pooled, a control account should be maintained to reflect the recorded values of each class of investments in the pool--bonds, preferred stock, and common stocks.

Any school that operates an investment pool must adopt procedures to assure equitable distribution of income and equitable assignment of capital appreciation to all the funds that make up the pool. We strongly recommend the market value method over the cost method for assigning share value to income funds.

As funds are added to or taken away from the pool, the school must take care to assure that all funds receive their fair share of investment income as well as realized and/or unrealized capital appreciation.

The following guidelines for operating investment pools are offered in College and University Business Administration.

Investment earnings are distributed to the various participating funds on the basis of the assignment to each fund of a number of units calculated on the market value of the assets in the pool at the time of entry of each fund into the pool. This procedure is known as the "market value" or "unit" method of accounting for investment pools. Under this method, when an investment pool is inaugurated, or when a change is made from the historic dollar value to the market value method, an arbitrary value, perhaps \$100, is assigned to a share or unit. Each institutional fund then is considered to have the number of units directly proportional to its historic dollar value at the time the market value is inaugurated. For example, if \$100 is assigned to each unit, a fund of \$10,000 has 100 shares.

Thereafter, the pooled assets are valued at specific intervals, usually monthly or quarterly, and a new unit value is determined by dividing the new total market value by the total number of units. This new unit value is used to determine the number of units assigned to, or "purchased" by, a new fund as it enters the pool. The new unit value also is used in calculating the value of a fund that may be withdrawn from the pool. For example, the market value of assets of an investment pool having a total of 100,000 units may be \$15 million at a given monthly or quarterly valuation date; the value of each unit, therefore, would be \$150 (\$15 million divided by 100,000 units). A new fund of \$30,000 entering the pool on that date would be assigned 200 units (\$30,000 divided by \$150). Also, a fund holding 300 units being withdrawn from the pool would have a value of \$45,000 (300 units multiplied by \$150).

In making distributions from the pool, the total investment earnings are divided by the average number of units held by all funds participating in the pool during the year or period in order

to determine the distribution per share. Earnings are distributed at this rate on the basis of the number of units held by each fund, with suitable adjustments made for units held for less than a full year or period.

Either of two procedures may be followed in admitting funds to or withdrawing funds from the pool. One is to admit funds to or remove them from the pool only on valuation dates. The other method is to admit or remove them at any time, the valuation of units being that of the latest valuation date. (Under provisions of the Tax Reform Act of 1969, this method cannot be used for pooled life income funds.) If the latter method is employed, unit values should be determined with sufficient frequency to avoid inequities resulting from undue variations in unit market value.

An account for realized gains and losses on investment transactions usually is established for each investment pool. This account is charged or credited for unit valuation adjustments upon withdrawal of participating funds from the pool. Upon withdrawal, a fund receives assets equal in value to the market value of the units it held in the pool at the withdrawal date or the last valuation date. The difference between the historic dollar value upon entry and the withdrawal value represents a portion of the aggregate of realized gains and losses and unrealized appreciation of the portfolio. Accordingly, upon withdrawal of a fund, the difference is charged to the realized gains and losses account as an appropriate disposition of the adjustment. If the aggregate of unit adjustments is material in relation to undistributed realized gains and losses, a separate account could be established and appropriate disclosure made in the balance sheet.

The realized gains and losses account is not assigned shares in the investment pool, and no revenue is distributed to it. Thus, the revenue otherwise allocated to the account is distributed to each of the funds participating in the pool in proportion to the number of units held by each fund.

An institution may distribute gains and losses annually to each fund in the pool. However, most institutions do not regard the additional work involved as justified.

Realized gains and losses on separately invested funds should be distributed directly to the funds; thus, the fund balance changes each time an investment is sold and a gain or loss is realized.

In the past, many colleges and universities followed the historic dollar value method of distributing revenue. When there was little or no change in the valuation of assets held, this method equitably distributed investment revenue. However, because equity securities and other assets that fluctuate in value are of increasing importance to investment pools, the market value method provides a more equitable distribution of revenue and realized and unrealized gains and losses to each fund. The historic dollar value method is

no longer considered acceptable. As a collateral advantage, fluctuations in unit value of the pool provide a useful measure of performance of the investment pool, undistorted by additions or withdrawals of funds.¹

2. Buildings or Other Plant Assets

Buildings or other plant assets held for investment purposes should be depreciated in computing available income. In this context, depreciation reflects a return of principal and thus should be offset in measuring investment income. This depreciation should be funded as the asset is wasting as time passes.

D. Pledges Receivable

We recommend that pledges receivable (including subscription notes and estate notes) not be recorded in the accounts of the school or be shown in the body of the financial statements. However, significant amounts of pledges receivable and their expected maturities should be disclosed in a footnote if it appears likely that they will be collected.

IV. Valuation of Liabilities

Liabilities reflect economic obligations owed by the school. Valuation of liabilities for independent schools follows the same principles that are generally accepted for commercial enterprises.

V. Revenues and Other Fund Additions

A. Classification

Revenues of the school should be recorded on an accrual basis in the appropriate fund groupings and be classified by major sources.

¹College and University Business Administration, 3rd ed. (Washington, D.C.: NACUBO, 1974), sec. 4.1, pp. 8-9, quoted by permission of the National Association of College and University Business Officers.

These sources include student tuition and fees, investment income (dividends and interest), revenues from auxiliary services, revenues from affiliated enterprises, other income, and gifts.

B. Revenues from Students

Revenues from students should include all tuition and fees assessed, whether the amounts are collected or not. Uncollectable tuition and fees should be accounted for as an operating expense.

If the tuition bill includes a capital assessment, this assessment should be recorded as revenue of the plant fund.

We recommend that tuition revenue be recorded before deducting financial aid. That is, tuition revenue should equal the tuition amount per student times the number of students enrolled. Financial aid in the form of scholarships, fee waivers, or tuition remission should not be netted against tuition revenue. Some schools still show tuition net of financial aid in the annual financial report. This practice is not recommended, and disclosure is considered adequate only if the gross amount of financial aid is clearly shown, including amounts funded by gifts and other revenue restricted for financial aid.

C. Investment Income

1. Dividends and Interest

The full amount of dividends and interest earned during the year should be recorded as investment income of the fund grouping in which the investments are recorded. When investment income from endowment funds is used for operations, it should be recorded as a transfer of funds from endowment to operating. Accordingly, dividends and interest are recognized as revenue in the year earned, whether or not the

amount is expended for operations. The decision by the trustees either to spend the income or reinvest it affects the size of the transfer to the operating funds, but it does not affect the determination of earned income. Although we do not recommend it, another acceptable practice is to record endowment income directly as revenue of the operating funds and to by-pass the endowment funds altogether when the income is allocated for operations as soon as it is received.

If investments are pooled, all income therefrom should first be credited to an undistributed pooled investment income account. Distribution from this account to the various funds comprising the pool should be made at least once a year. As discussed above, this income should be allocated on the basis of the number of shares in the pool held by each fund, adjusted for shares held less than a full year.

For fixed-return securities held, interest income should include amortization of any discount or premium.

2. The Total-Return Concept

Some independent schools, like some colleges and universities, follow the "total-return" approach, in which not only dividends and interest but also some portion of average capital appreciation are considered available to be spent for operations each year. The concept of treating a portion of capital appreciation as income rather than as an increase in principal is still controversial. In some states, it is specifically permitted by statute. In other states, the applicable law seems to prohibit the spending of any capital gains. In still other states, the question of legality is very unclear, with some attorneys believing that "total return" is legal and other attorneys believing that it is not.

Whether the concept is legal or not, there is also substantial disagreement whether spending a portion of average capital gains represents prudent financial management.

Chapter 8 of the 1973 American Institute of Certified Public Accountants' audit guide, Audits of Colleges and Universities, gives a very good summary of the legal and economic issues related to the "total-return" concept. The AICPA concludes that, until a much clearer consensus evolves on this issue, it is not appropriate to sanction as a permissible accounting procedure the inclusion of any capital appreciation in investment income earned. We support the AICPA's conclusion. We also encourage further consideration of this subject by all independent schools having significant endowment funds so that a consensus may emerge.

The fact that this manual does not sanction recognizing capital appreciation as income at this time should in no way inhibit the application of the "total-return" concept as an investment management policy in those schools that think it has economic merit. As long as capital appreciation appropriated for operations is accounted for as a transfer of funds, "total return" can be applied as an investment management policy without violating the prohibition against recognizing capital appreciation as income.

D. Gifts

1. Unrestricted Gifts

All unrestricted gifts and bequests should be reported as revenue of the unrestricted operating fund in the year they are received. If any amounts are appropriated for uses other than current operations, these amounts should be reflected as transfers from the operating fund

to the fund grouping for which they are appropriated.

Another acceptable practice is first to record all gifts in a "development" or unrestricted gift fund and then to transfer amounts to other funds as the trustees deem appropriate. Under this approach, when the gifts are received they are recognized as revenue of the fund to which they are first applied. Subsequent allocations to other funds (including the unrestricted operating fund) are then recorded as interfund transfers.

2. Restricted Gifts

a. For Operations

Restricted gifts for operating purposes may be recorded in one of three ways. Under one approach, they are recorded as revenue of the restricted operating fund when they are received. As they are expended, they will show up as operating expenses in this same fund. If gifts to be spent over more than one year are received, this will result in showing a surplus of revenues over expenses in the restricted operating fund in the year of the gift and a deficit in the following years over which the expenditures are spread. Such a situation requires careful attention in assessing the overall surplus or deficit for the school in the years affected. It is, however, consistent with the concept of recognizing gifts when they are received and expenses when they are incurred.

Under the second approach, the gifts are not treated as income until the year they are expended. This method matches revenues and expenses but does not record gift income as received if the gift is to be spread over more than one year.

The third approach is to debit cash and credit unearned income upon receipt, and to debit unearned income and credit appropriate expense upon expending.

Each of these approaches is acceptable. The first two have support among independent schools. NACUBO strongly favors the second and third approaches.

b. For Endowment or Plant

Restricted gifts for endowment or plant should be recorded when received as additions to the fund grouping for which they are intended.

3. Gifts in Kind

a. Securities

Gifts of marketable securities that are intended to be sold by the school to generate cash may be accounted for in one of two ways.

The estimated fair market value of the securities may be recorded as gift income at the date of receipt of the gift. When the securities are later sold, there will probably be a gain or loss based on the recorded value of the securities, which should be accounted for as an adjustment to gift income.

To avoid showing gains or losses upon sale, the securities may be recorded only in a memo account when they are received and the gift income not be recorded until the securities are sold. Normally, the holding period should not exceed one year. If this approach is used and securities remain unsold at the end of the fiscal period, they should be recorded at estimated fair market value as of the end of the year and be included in gift income for the current year. We recommend this approach for securities that do not have a readily determinable market value.

b. Art Objects and Similar Gifts in Kind

Items other than marketable securities (paintings, sculpture, antiques, etc.) that the school receives with the intention of selling them to generate cash should be recorded only in a memo account when they are received. When the sale is completed and the net cash proceeds are known, this amount should be recorded as gift income.

Because of the high uncertainty about the amount to be realized from the sale of such items, we recommend that they not be recorded as gifts until the actual cash income is known.

Gifts of non-income-producing assets that are received with the intention of holding them should be recorded under plant assets at their estimated fair value at the date of receipt.

4. Contributed Services, Materials and Supplies, or Plant Assets

To assess the full operating expenses of the school properly for purposes of comparison over time or across schools, it is very important to record all significant services and materials used in the accounts at full value. Accordingly, the estimated fair market value of significant contributed services, materials and supplies, or plant assets must be determined, maintained in the regular operating expense accounts, and reported separately as gift income in the financial statements.

Contributed services include volunteer classroom teachers, teacher aides, library assistants, office help, coaching, legal or auditing services, and other services that, if not donated, would have to be paid for. This category does not include trustees, class agents, parent council members, student work programs, or other services that are uniformly donated, rather than paid for, in independent schools. To exchange such

services for partial or full tuition waivers is illegal and can result in loss of the school's tax-exempt status. The estimated value of contributed services can be determined by looking at the salaries of people who are paid for performing equivalent functions in the school or in similar institutions. Comparative wage and salary data are also available from NAIS, the U.S. Office of Education, and the National Education Association.

Gifts of materials and supplies include food, building materials, vehicles, and the like. The value of these items for the school's records may be estimated with the aid of dealers in these objects, newspaper advertisements, and price books such as the NADA Official Car Guide. If these objects are donated with no expectation of gain by the donor, he may treat them as gifts in computing his income for tax purposes, in which case the donor should set the value.

Gifts of plant assets should be recorded when received as gift income of the plant fund and as additions to the plant assets. Such gifts should be valued at estimated fair market value at the date of receipt.

5. Pledges

Pledges should not be recorded as gift income until they are honored.

E. Auxiliary Services

Auxiliary services are those functions needed to operate the school that are not part of the instructional program--lunchroom, infirmary, student store, laundry, transportation.

If the school charges a single combined fee for tuition and meals and room (in boarding schools), it is considered acceptable practice to report the fee as a lump sum under the heading "tuition" or "student fees."

If, however, the school publishes or maintains internally a breakdown of its fees for tuition, meals and room, and such other services as health, laboratory, extracurricular activities, and the like, the respective revenue amounts should be separately recorded and reported.

Expenses related to auxiliary services should not be netted against fee revenues in the books of account.

It is especially important that separate accounts be maintained for both revenues and expenses for those auxiliary services or miscellaneous programs that are optional and for which fees charged should at least cover costs--the bookstore, a voluntary busing program, a summer camp, or the food service operation.

F. Affiliated Enterprises

Some schools operate business enterprises that are not related to their educational program, such as an inn maintained as a service to people visiting the campus or a working farm or thrift shop operated to generate income for the school.

Separate revenue and expense accounts should be maintained for each affiliated enterprise so that its economic position can be assessed accurately. For reporting purposes, expenses should be netted against revenues and the net balance reported. Legal counsel should be consulted concerning the income and property tax status of affiliated enterprises.

G. Other Income

Other income items should not be netted against expenses. Such revenues should be separately recorded and, if material, separately reported.

VI. Expenses and Other Reductions in Fund Balances

A. General Comment

Operating expenses should be recorded in such a way that it is possible to summarize them both in terms of broad functional and departmental categories and also in terms of natural expense or "object of expenditure" categories. A proposed classification scheme is given in Chapter 2.

Nothing in this manual should be construed as prohibiting whatever special accounting procedures or classifications are necessary to comply with regulations or statutes that require special accounting reports.

The major expense categories in the books of account should be as follows: instruction, auxiliary services, operation and maintenance of plant, general and administrative, and financial aid. This framework should also be carried through to the Statement of Revenues, Expenses, and Other Changes in Fund Balances. Classification of individual expense items within these categories is discussed in Chapter 2.

We recommend recording operating expenses first by function, then by department within a function, and finally by object of expenditure within a department.

B. Provisions for Plant Replacement, Renewal, and Special Maintenance

Provisions should be made among the operating expenses of the school for using up those plant assets classified in category c on pages 19-20. Assets that are donated and for which future replacement is expected to come from future donations do not have to be considered, since operations do not need to generate revenues to cover such expenditures. For many classes of plant assets, however, operating revenues are the principal

source of the funds used for replacement or renewal. For these classes of assets, the expenditures should be charged ratably as an operating expense and funded over the years that benefit from the use of the assets. This is necessary for three reasons: (1) to assess fairly each year the relation between operating revenues and expenses; (2) to avoid operating at a deficit in the years when major replacements or renewals are necessary; and (3) to provide funds to cover such expenditures.

Purchases of category c equipment (see pp. 19-20) and expenditures for replacement of major components of buildings such as heating systems, roofs, or plumbing systems should not be recorded as an immediate expense of the operating fund. Operations should be charged ratably over the period during which the assets are used, as explained below. As noted on page 19, year-to-year expenditures for items in category b are expensed directly. This is acceptable only because the result still approximates charging as expense each year the portion of the asset base used up that year.

The accounting procedure for charging operations ratably for replacement and renewal of category c plant assets involves the use of an operating expense account called "provision for plant replacement, renewal, and special maintenance." In using this account, the school must first calculate the average amount that would have to be set aside each year to provide money for the purchase of school equipment (athletic, automotive, kitchen, etc.) as it needs to be replaced, and to provide money for irregularly timed major renewal expenses related to buildings. This calculation takes into account the following considerations.

The composition of the school's equipment accounts

The useful lives of the various equipment items

The anticipated costs of replacing equipment as it wears out

The useful lives of the major components of buildings that require periodic replacement if the buildings are to remain usable

The anticipated costs of these renewal expenditures

Once the required average annual expenditure is calculated, this amount is charged against operations as "provision for plant replacement, renewal, and special maintenance," with a corresponding amount of cash being set aside as a separate fund within the unexpended plant funds. This fund is then invested to earn interest until replacement or renewal expenditures are required. When such expenditures are made, they are charged against this fund rather than against operations. School operations, of course, have already been charged each year for a fair share of such expenditures, reflecting the estimated portion of the expenditures used up in any one year.

Once this accounting procedure is instituted, it may take several years to accumulate any substantial reserves. The amount set aside should be re-evaluated each year, since conditions in the school change. If the amount is adequate, as outlined above, the fund called "provision for plant replacement, renewal, and special maintenance" should eventually grow to the point where all replacement and renewal expenditures for category c plant assets (pp. 19-20) are provided for. At that point, the decision about when to make such expenditures can be arrived at rationally, without concern for how much the current operating budget can "afford." The result, over time, should be a significant reduction in the level of necessary maintenance and renewal projects that have been postponed or

"deferred" and an upgrading of the overall condition of the school's operating plant.

We recommend that all independent schools provide annually in this manner for the unavoidable wear and tear to those plant assets that we have classified as category c. Because these plant assets cannot be presumed to be funded from donations, systematic provision in the operating budget is a necessary aspect of prudent school management.

C. Faculty Salaries

Faculty salaries should be charged as expenses in the fiscal year in which the teaching is done, even if salary payments extend over two separate fiscal years (e.g., July and August payments when the school's fiscal year ends June 30).

Salaries paid to faculty members for teaching in summer sessions should not be charged to two separate fiscal years. Instead, the full amount of summer compensation should be charged to the year in which the predominant portion of the summer session falls. As a basic principle, recognition of the expense should correspond to recognition of the revenue.

D. Financial Aid

Financial aid should be reported on a gross basis as a separate category of expense. Income restricted for financial aid purposes should be disclosed in a footnote. Such income should not be netted against the expense for accounting or reporting purposes. It is important to disclose both the total amount of financial aid granted and the extent to which such expenditures are met by restricted income (gifts or dividends and interest).

Tuition remission granted in full or in part to children of faculty members is considered part of financial aid.

E. Auxiliary Services

We recommend that a separate set of expense accounts be maintained for each auxiliary service to facilitate budgeting for each separate service, which in turn facilitates cost controls through periodic "budget vs. actual" or "year to year" comparisons.

For financial reporting purposes, both revenues and expenses of all auxiliary services should be shown on a gross basis in the Statement of Revenues, Expenses, and Other Changes in Fund Balances.

VII. Interfund Borrowing and Transfers

A. General Comment

All transfers or borrowings between funds should be approved explicitly by the board of trustees. Interfund borrowings should be temporary in nature.

When the expectation of repayment of interfund loans is low, the school should consider recording the transaction as a permanent transfer.

B. Financial Reporting

In the statement of financial position, all interfund balances ("due from" and "due to") for each fund grouping should be netted into one combined amount for each fund grouping and be shown as the last item under "assets." When this line is added across for all fund groupings, the combined total will be zero. A separate schedule should be included with the financial report reconciling all "due from" and "due to" balances when such balances are significant. An example of such a schedule is shown in Exhibit 4-6 (p. 87).

Netting of interfund liabilities against interfund assets for each fund grouping would not normally be considered good accounting practice.

Nevertheless, as illustrated in Chapter 4, the overall result provides what we consider to be the most informative way of summarizing this aspect of the financial position of the school.

Chapter 2

THE CHART OF ACCOUNTS

The chart of accounts is the system by which financial data are classified and accumulated for clear financial reporting. This chapter outlines the structure of a recommended chart of accounts for independent schools, explains that structure, and describes the accounts contained in the chart. A sample chart of accounts for an actual independent school that follows the recommended format is also included.

The primary goal of any accounting system is the meaningful disclosure of financial information. The chart of accounts is nothing more than a means of achieving that goal. The chart we recommend here involves some significant changes from the chart recommended in the first edition of this manual. In the interest of comparability across schools, we encourage all schools to adopt the concepts recommended here. Comparability among schools of the definitions and descriptions of accounts is more important than uniformity of the number code assigned to those accounts. Thus, schools already having an account numbering system that summarizes financial information in accordance with the categories of expenditure recommended here do not need to change their existing charts.

The structure and numbering scheme outlined below can be regarded as one appropriate way for a school to develop financial data within the recommended framework of basic accounting principles. Within that structure and numbering scheme, each school should determine the precise level of detail necessary for its own financial reporting and control requirements. Subsidiary ledgers may be used to classify detail accounts with respect to

cash, student accounts receivable, payroll, investments, endowment funds, and the like.

Regardless of the numbering system used, we encourage all schools to adopt the classification and categorization scheme recommended here.

I. Allocating Expenses

This chart of accounts does not involve the allocation of expenses among major functional categories except for payroll amounts and employee benefits, which are allocated to instruction, auxiliary services, plant, and administration in order to reflect fairly the full cost of personnel services within each of these functions. We recommend a simple allocation scheme for employee benefits whereby each of the functions is charged with a share of total payroll taxes and other employee benefits equal to that function's share of the total salaries and wages paid by the school.

For other expense items, such as utilities or maintenance, which might benefit more than one function, the extra effort involved in allocating the expense is normally not justified by the increase, if any, in the significance of the results.

Whenever information about the "full cost" of a particular service, program, or function is desired, the "full cost" information should be compiled on a special analysis basis. Determining the cost of a service, program, or function depends heavily on the context in which this cost information is being used. One famous accountant is quoted as saying, in connection with an Interstate Commerce Commission rate hearing, that "not even God almighty knows the true cost of moving a ton of freight by rail from New York to Baltimore!" The kind of cost measurements to be made depends on the kind of decisions to be made. Cost measurements that apply to

pricing decisions, for example, would not necessarily apply to decisions about adding or dropping services. The chart of accounts is primarily a means of achieving meaningful financial disclosure. When the chart of accounts is used to generate information for decision-making, care must be taken in selecting and summarizing the information.

II. The Coding System

A six-digit code is proposed for the accounts. The first digit specifies the fund grouping. The second digit specifies the basic general ledger category (assets, liabilities, etc.). The third and fourth digits are used to provide detail, as appropriate, within the general ledger categories. The last two digits of the account number are used only for operating expenses. These digits reflect an "object of expenditure" breakdown.

A summary of the coding scheme is shown in Exhibit 2-1, which follows. This coding scheme is designed to make it easy to computerize the accounting records. All account numbers are of the same length. Each position within the account number has a particular meaning, as described above. The accounting information can thus be summarized in different ways by sorting the records according to different positions in the account code.

As noted, the fifth and sixth digits of the account code are used for further classifying expenses of the school. These digits reflect the breakdown of expenses by what are sometimes called "natural expense" classifications or "object of expenditure" categories. A detailed listing of the recommended object of expenditure classifications is shown in Exhibit 2-2 (pp. 46-49).

Exhibit 2-1

Summary of the Structure of the Chart of Accounts

A. First digit - fund classification

- 1 Operating - unrestricted
- 2 Operating - restricted
- 3 Endowment - unrestricted
- 4 Endowment - restricted
- 5 Plant - unexpended
- 6 Plant - investment in plant
- 7 Annuity and life income
- 8 Loan
- 9 Other

B. Second digit - general ledger category

- 1 Assets
- 2 Liabilities
- 3 Fund balances
- 4 Revenues earned
- 5 Expenses incurred
- 6 Gifts received
- 7 Transfers

C. Third digit - account classification

Assets

- 1 Cash
- 2 Investments
- 3 Accounts and notes receivable
- 4 Inventory
- 5 Prepaid expenses and deferred charges
- 6 Land, buildings, and improvements
- 7 Equipment
- 8 Other assets
- 9 Interfund balances - due from

Liabilities

- 1 Notes payable - short-term
- 2 Accounts payable
- 3 Accrued liabilities - payroll and related
- 4 Accrued liabilities - other
- 5 Agency funds
- 6 Unearned revenues and deferred credits
- 7 Long-term liabilities
- 8 Other liabilities
- 9 Interfund balances - due to

C. Third digit - account classification (cont.)

Fund balances

-
-
-
-
-
-
-
-
-

Revenues Earned

1 Student tuition and fees
2 -
3 Student activities
4 Auxiliary services
5 Other programs
6 -
7 Dividends and interest
8 Affiliated enterprises
9 Other income

Expenses Incurred

1) Instruction
2)
3 Student activities
4 Auxiliary services
5 Other programs
6 Operation and maintenance of plant
7 General and administrative
8 Affiliated enterprises
9 Financial aid

Gifts Received

1 Alumni/ae
2 Parents
3 Trustees
4 Grandparents
5 Friends and others
6 Corporations
7 Foundations
-
-

Transfers

1 Transfers out
2 Transfers in
-
-
-
-
-
-
-

D. Fourth digit - detailed subclassification of the third-digit account. For each third-digit account, ten detailed accounts may be maintained. For assets and liabilities, the detail could be by individual accounts. For expenses, the fourth digit would signify the department within a function.

E. Fifth and sixth digits - "object of expenditure" classification for expenses incurred. These digits will be 00 in all other accounts. If more than ten detail accounts are needed for any asset or liability account categories, the fifth digit may be used. Using the fourth and fifth digits, 100 detail accounts may be maintained for each third-digit account category.

Exhibit 2-2

Fifth and Sixth Account Digit Classifications

The following classifications are recommended for the fifth and sixth account digits, which are used for recording expenses by object of expenditure. Those not listed (e.g., 12, 18) may be assigned by the school.

<u>Object Number</u>	<u>Description</u>
10	Personnel services
11	Instruction salaries
13	Administration salaries
14	Secretarial and clerical salaries
15	Other staff salaries
16	Student assistants' salaries
17	Dormitory parents or counselors
19	Estimated value of contributed services
20	Employee benefits - taxes and insurance
21	FICA tax
22	Unemployment tax
23	Workmen's Compensation
24	Medical and hospitalization insurance
25	Major medical insurance
26	Retirement insurance
27	Life insurance
28	Disability insurance
29	Other
30	Employee benefits - other
31	Grants-in-aid

<u>Object Number</u>	<u>Description</u>
32	Moving expenses
33	Pensions paid
34-38	Other
39	Employee benefits applied (illustrated in Chapter 3)
40	Materials and supplies
41	Supplies used - instructional
42	Supplies used - office
43	Supplies used - general
44	Provisions (raw food)
45	Cost of merchandise sold
46	Estimated value of contributed items
50	Plant-related
51	Electricity
52	Fuel
53	Water
54	Equipment purchases charged to expense
55	Provision for plant replacement, renewal, and special maintenance
56	Property taxes
57	Equipment rentals
58	Fire and casualty insurance on property assets
60	Information and communications
61	Subscriptions, publications, and reports purchased
62	Membership dues
63	Telephone

<u>Object Number</u>	<u>Description</u>
64	Printing and binding
65	Postage and shipping
66	Advertising
67	Photocopying
68	Special publications produced
70	General expenses
71	General liability insurance
72	Interest
73	Other taxes
74	Professional fees
75	Rent expense
76	Provision for uncollectable accounts
77	Travel
78	Entertainment
80	Other expenses
81	Contracted services
82	School head's discretionary fund - applies only to discretionary expenditures di- rectly related to school business
83	Governing board
84	Assemblies and convocations
85	Conferences and workshops
86	Summer study for faculty
87	Sabbatical leave expense
88	Commencement expense
89	Sundry

<u>Object Number</u>	<u>Description</u>
90	Continuation of other expenses
91	Financial aid - tuition and fees
93	Financial aid - incidental expenses
94	Prizes and gifts awarded

III. Account Descriptions

The following descriptions do not cover every account grouping in Exhibit 2-1, the recommended chart of accounts. Descriptions are provided only for those accounts that tend to raise questions about classification or account procedures. Also, the descriptions occasionally deal with items not specifically named in the exhibit. The use of "X" in the text indicates that the detail may apply to any first-digit fund classification.

Assets (X-1-00-00)

Cash (X-1-10-00). A separate account should be established for each bank checking and savings account. Separate accounts should also be maintained for petty cash funds and for change funds maintained by the bursar or other individuals.

Investments (X-1-20-00). Includes securities held for investment purposes (treasury bills and notes, certificates of deposit, etc.) or securities received as gifts for current operations. Detail accounts might consist of

Short-term bills and notes

Bonds

Preferred stock

Common stock

Mortgage notes

Real estate

Accumulated depreciation - real
estate (credit balance)

Accounts Receivable (X-1-30-00). A separate general ledger control account should be established for student accounts, advances to students,

faculty members, staff, and any other material amounts due the school. The data for each individual account should be maintained in a subsidiary ledger controlled by the general ledger account. Accounts receivable should be shown at face value and a separate account called "allowance for uncollectable accounts" (credit balance) be used to recognize that portion of the receivable that may not be collectable. Account X-1-39-00 may be used as the allowance account.

Notes Receivable (X-1-30-00). May be classified under accounts receivable unless substantial.

Allowance for Doubtful Accounts (X-1-30-00). See accounts receivable, above.

Inventory (X-1-40-00). Use as many accounts as are needed for (1) merchandise for sale, and (2) materials and supplies used in the school. For example, inventory accounts might be maintained for food and provisions, maintenance materials, athletic supplies, items for sale to alumni, bookstore materials, and the like. The cost of such items should be charged to expense as they are used or sold and the same amount credited to inventory at that time. Materials and supplies that are rapidly consumed in normal operations and are of small dollar value (light bulbs, nuts and bolts, soap, etc.) should not be maintained in inventory accounts but rather be charged directly to expense as purchased. Physical inventories should be taken periodically, and the respective inventory accounts should be adjusted to actual value.

Prepaid Expenses and Deferred Charges (X-1-50-00). Represents advance payments by the school for goods or services that are properly chargeable to subsequent fiscal periods. An example is a prepaid insurance premium that covers a period of years. At the time when such goods or

services are used, the expenditure should be charged to current operations and the prepaid account reduced.

Land and Buildings (X-1-60-00). Represents the cost, or appraised value at time of donation, of land and buildings used for school purposes, including dormitories, faculty housing, athletic facilities, and the like. If desired, separate accounts may be maintained for the cost of major renovations and improvements to buildings. Buildings held as endowment for the purpose of generating income are also classified here, but are part of endowment rather than plant funds.

Construction in Progress (X-1-60-00). Represents the cost of uncompleted construction in progress. When construction is started and unexpended plant funds are disbursed, a temporary expenditure account should be opened for construction in progress. All costs pertaining to the project should be charged to this account. When construction is completed, the account is closed and the amount transferred to the appropriate plant asset account.

Improvements Other than Buildings (X-1-60-00). Represents the cost of major improvements, such as athletic facilities. Major improvements to buildings, including renovation, may be included in the buildings account or in a subaccount for improvements under the buildings classification.

Equipment (X-1-70-00). Includes the cost, or appraised value at time of donation, of major pieces of equipment, such as tables, chairs, audio-visual equipment, motor vehicles, maintenance equipment, office equipment, data-processing equipment, and the like. Library books may be included in this category.

Other Assets (X-1-80-00). Includes miscellaneous deposits (air travel

cards, utilities), cash value of life insurance, and the like.

Due from Other Funds (X-1-90-00). Represents amounts temporarily made available to other fund groups (such as operating funds loaned to the plant funds group). These accounts should not be used for permanent transfers between fund groups.

Liabilities (X-2-00-00)

Notes Payable (X-2-10-00). Represents liability for notes outstanding covering short-term borrowings for current operations. Any indebtedness for physical plant should be maintained under long-term liabilities rather than in this account.

Accounts Payable (X-2-20-00). Represents liabilities for goods received (usually shown on an invoice), but not yet paid for. Agency funds could be included here as a separate payable account.

Agency Funds (X-2-50-00). Represents the unexpended balance of any funds held by the school as an agent in connection with such activities as school clubs.

Unearned Revenues (X-2-60-00). This account is normally used to record tuition payments received in one year that are applicable to the following year's operations.

Revenues Earned (X-4-00-00)

Student Tuition and Fees (X-4-10-00)

Tuition. Includes all tuition assessed against students for operation of the regular school-year program, net of refunds. Separate accounts may be maintained for day and boarding tuition, if desired. For boarding schools that separate tuition from room and board charges, this account includes only the tuition portion.

Application Fees. Application fees should be recorded as revenue in the year received.

Registration Fees. If a registration fee is charged at the time of admission, such a fee should be taken into revenue when the student enrolls. If, however, the registration fee represents a partial prepayment of tuition, it should be credited to the liability account for unearned revenues. The unearned revenues account would then be debited at the beginning of the appropriate semester and the accounts receivable account be credited for the amount of prepayment.

Instructional Fees. These are fees related to the instructional program, such as lab fees, private lessons, tutoring, athletic fees, textbook charges, and the like.

Fines and Assessments. Includes library fines, breakage charges, identification card fees, key rentals, and similar items assessed against students. This category does not include capital assessments included with tuition.

Other Fees. Includes any fees for operating purposes that cannot logically be included in one of the above classifications.

Student Activities (X-4-30-00). Fees for activities that are not part of the instructional program, such as horseback riding, may be classified here and be separately disclosed, if substantial in amount. The revenue from subscriptions and admission to student activities, such as school newspapers and magazines, yearbook, theater, athletic events, and so on, can also be recorded here. Revenues from charges for organized school events would also be included. Separate accounts should be maintained for such significant items. One possible classification is

31 School newspaper

- 32 Yearbook
- 33 School magazines
- 34 Theater or student productions
- 35 Athletic events
- 36 Trips and excursions

Auxiliary Services (X-4-40-00). The gross revenues of auxiliary services during the regular school year should be recorded here and be separately identified. Auxiliary services are those services of a nonacademic nature that are provided to students.

Room (X-4-41-00). Student fees for rooms, if separate charges are made.

Board (X-4-42-00). Student fees for meals, if separate charges are made.

Health Services (X-4-43-00). Student fees for specific medical services, including reimbursement under medical insurance plans.

Student Stores (X-4-44-00). Gross sales of store or stores selling books, athletic equipment, clothing, toiletries, and the like.

Snack Bar (X-4-45-00). Gross revenues.

Laundry (X-4-46-00). Student fees for laundry, if separate charges are made.

Student Transportation (X-4-47-00). Gross revenues for transportation services such as school buses, trains, and so on.

Other. Gross revenues of any other student auxiliary services.

Other Programs (X-4-50-00). Following is a possible classification scheme for the third and fourth digits.

Summer School (51). If desired, the total current operating revenue may be reported here by source, such as tuition, fees, and auxiliary

services. All revenues of one summer session should be included in one school year rather than being split between two years. All expenses of the summer school should be recorded in the same year that the revenue is recognized.

Summer Camps (52). Gross revenues of school-sponsored or -affiliated camps.

Conferences and Workshops (53). Revenue from fees charged for programs that are not part of the regular instructional program of the school.

Public Services (54). Revenue from adult education courses or other programs of community service.

Dividends and Interest (X-4-70-00). This category includes all dividends received or accrued on common and preferred stocks as well as all interest received or accrued on fixed-return securities owned, including amortization of bond discount or premium, if any.

Affiliated Enterprises (X-4-80-00). Represents revenues earned by any enterprises operated by the school that are not related to the instructional program and that operate with separate facilities, such as an inn, a thrift shop, or a working farm.

Other Income (X-4-90-00). Includes all revenue amounts not classified elsewhere, such as incidental rental income, proceeds from the sale of equipment, government appropriations or subsidies, and so on. Miscellaneous expenses should not be netted against miscellaneous income items.

Expenses Incurred (X-5-00-00)

Instruction (X-5-10-00 and X-5-20-00). This category includes all expenses of the instructional program, which is defined as including

those activities that are directly related to the learning, growth, and development of students. Within the instruction category, we recommend that all salary and employee benefit expenses be collected in one unit, not broken down by department or program. Within this combined unit, the salary and related benefits expenses are classified by object of expenditure. We do not recommend that instructional salaries and employee benefits be broken down by department because of the major extra effort required to accomplish this task. For purposes of special cost analyses, salaries and employee benefits by department or program can readily be reconstructed from payroll records. The object of expenditure breakdown for salaries and employee benefits should be as follows.

Personnel Services (salaries, wages, and contributed services)

Instruction. Personnel who are directly engaged in the learning, growth, and development of students--teachers, librarians, coaches, chaplains, audio-visual personnel, guidance personnel, psychological counselors, work-study coordinators, student placement counselors, and the like. For the purpose of NAIS comparative studies, these personnel are broken down into "teaching" and "instruction support" categories, as defined in the NAIS questionnaire. Such a distinction can also be maintained in the chart of accounts, if the school wishes.

Administration. Personnel who directly administer the instructional program, as defined above, such as department heads, division heads, dean of faculty, academic dean, or dean of students. The salaries of any people involved in both instruction and instructional administration should be prorated between these two functions.

Clerical. Personnel who provide direct clerical support to people involved in either instruction or instructional administration. If

clerical personnel divide their time between instructional administration and other administration, it is not necessary to allocate a portion of their salaries to instruction. Instead, their salaries can be charged under general and administrative expenses.

Dormitory Parents. In boarding schools, people who serve as dormitory parents but are not employees of the school in some other capacity should be charged here. Thus, this category should include only people whose salary is not included elsewhere in the operating expenses. Allocating a portion of a teacher's or administrator's salary to this category is not considered desirable.

Employee Benefits Applied. This category includes the portion of payroll taxes and other employee benefits paid by the school that is applicable to salaries and wages under instruction. See sample journal entry 14 in Chapter 3, page 76, for an illustration of applying such benefits.

Other Instructional Expenses. We recommend that expenses other than salaries and employee benefits be broken down by departments or programs. Since these expenses are very difficult to reconstruct on a departmental or program basis after the fact, it is important to collect them by department or program from the outset, which also makes it easier to prepare special cost analyses later on. A departmental breakdown, for example, might show English, mathematics, science, foreign language, and so on. A program breakdown by grade level might be more appropriate and useful in an elementary or middle school. The instruction category should include the direct academic departments or programs and, if applicable, the following departments (with the third and fourth digits shown here).

Chapel (25). If the school conducts a chapel or vespers program, it is considered to be part of the instructional program.

Athletics (26). Athletic and physical education programs are considered to be instructional programs.

Library (27). The library is considered to be an instructional program.

Student Guidance and Counseling (28). Student guidance and counseling are considered to be part of the instructional program.

Instructional Administration (29). Administration of the instructional program is considered a separate "department" or "program" within the instruction category.

Within each department or program, the breakdown of expenses should include direct expenditures for materials and supplies, plant-related expenses, information and communications, and general and other expenses. In the chart of accounts code proposed on pages 44 and 45, this would include all expenses in object of expenditure codes 40, 50, 60, 70, and 80.

Student Activities (X-5-30-00). This category includes expenses for student-related activities that are not considered to be part of the instructional program. Typical examples of such activities are listed under "Revenues - Student Activities (X-4-30-00)" on pages 54 and 55. It is probably not practicable to allocate to these activities a portion of the salaries and employee benefits of the faculty members who supervise them. Each activity should be charged for all direct expenditures for materials, supplies, contracted services, and equipment. It is important that the numbering scheme (third and fourth digits) for revenues correspond with the one used for expenses.

Auxiliary Services (X-5-40-00). This category includes the operating expenditures of each auxiliary student service during the regular school year. The primary subclassification (fourth digit) is by service. Within

each service, the subclassification (fifth and sixth digits) is by object of expenditure. Allocation of indirect or overhead costs, other than employee benefits, should be avoided as an unnecessary complication. A suggested classification scheme (third and fourth digits) is as follows.

Food Service (42). Salaries and wages paid to dining room and kitchen staff, related employee benefits, and the cost of food, cooking supplies, linen, silverware, and dishes.

Health Service (43). Gross expenditures associated with the operation of the infirmary and related health services, including salaries and employee benefits for physicians, nurses, and other medical staff, and medicines and supplies.

Student Store (44). Total cost of operating the bookstore. If the inventory of the bookstore is carried on the balance sheet, the cost of goods sold during the year may be determined by adding the year's purchases to the opening value of the inventory and subtracting the value of the inventory at the end of the year.

Snack Bar (45). Total cost of operating the snack bar.

Laundry (46). Direct costs of operating the laundry, including salaries, employee benefits, supplies, and so on.

Student Transportation (47). Cost of providing transportation, such as busing, including all personnel, supplies, repairs, insurance, and related charges for the school's bus fleet.

Other Programs (X-5-50-00). The primary subclassification (fourth digit) is by program. Within each program, the subclassification (fifth and sixth digits) is by object of expenditure. A suggested classification scheme (third and fourth digits) is as follows.

Summer School (51). Accounts should be maintained for instruc-

tional expenses, administration, auxiliary services, and maintenance, including direct expenditures and allocations of employee benefits.

Summer Camps (52). The gross expenditures of summer camps operated by the school should be charged here.

Conferences and Workshops (53). Expenditures for special programs that are distinct from the normal academic program of the school, such as a teacher-training workshop, are included here. If such expenditures are not material, they may be included under "General and Administrative (X-5-70-00)."

Public Services (54). Included here are expenditures for school programs and activities that involve the community, such as adult and other educational classes, volunteer programs, and the like. It is important that the numbering scheme (third and fourth digits) for revenues correspond with the one used for expenses.

Operation and Maintenance of Plant (X-5-60-00). This category is used to accumulate the cost of operating, maintaining, and repairing the school's physical plant. Included, under the appropriate categories, are expenditures for personnel services, employee benefits applied, materials, supplies, equipment purchases expensed, and contracted services. Also included is the annual provision for plant replacement, renewal, and special maintenance described in Chapter 2 on pages 35-38. If desired, a six-way "departmental" breakdown (third and fourth digits) of expenses may be maintained, as follows.

Buildings (61). Expenditures for maintaining and insuring all buildings used in the normal operations of the school.

Cleaning (62). If desired, expenditures for cleaning school buildings may be accumulated in a separate department.

Grounds (63). Expenditures for landscaping, maintenance, snow removal, and other care of athletic fields and all other grounds used in the normal operations of the school.

Security (64). Expenditures for protecting school personnel and property.

Vehicles (65). Expenditures for repairing, operating, and insuring school vehicles used for maintenance and general purposes. Expenditures attributable to student transportation to and from school should be accumulated under that service classification.

Plant Administration and General (66). Expenditures not directly attributable to one of the other five categories are included here. Provision for plant replacement, renewal, and special maintenance would also probably be charged to this account, since it applies to school operations in general.

General and Administrative (X-5-70-00). The primary subclassification (fourth digit) is by department. Within each department, the subclassification (fifth and sixth digits) is by object of expenditure. If desired, all administrative salaries may be collected in one combined unit, and not be broken down by department. Alternatively, salaries may be charged to departments, if desired. Expenses other than salaries and employee benefits should be broken down by department if the school is large enough to have separate departments. One possible classification scheme (third and fourth digits) is as follows.

Head's Office (71). Expenditures for operating the office of the head of the school, including salaries and employee benefits, travel, entertainment, supplies, stationery, printing, head's discretionary fund (if any), and the like.

Admissions Office (72). The costs of screening, interviewing, and accepting students should be included--the salaries and employee benefits of the admissions officer and his or her staff, as well as expenditures for materials and supplies, bulletins and catalogues, admissions testing, travel and entertainment, and recruiting expense.

Business Office (73). All expenditures associated with accounting, purchasing, and general financial operations, including the salaries and employment benefits of the business manager and his or her staff, materials and supplies, rental of accounting equipment, printing and mailing, and so forth. Expenses associated with managing the investments of the school should also be included under this category. If desired, expenses associated with managing investments may be charged under endowment rather than operating funds.

Registrar's Office (74). All expenditures of the office that maintains student academic records, including the cost of preparing and mailing grades and comments, preparing student schedules and preparing and forwarding student transcripts, as well as the salaries and employment benefits of the registrar and his or her staff. If this work is done by the dean's or another office, these expenditures may be accumulated under that category.

Alumni/ae Office (75). All expenditures of the office, such as the alumni/ae bulletin and other publications and the expenses incurred by the school in holding regional alumni/ae meetings and reunions, as well as the salaries and employee benefits of the director and his or her staff. If fund raising is conducted by this office, such expenditures can also be collected and identified under this category.

Development Office (76). Expenses of long-range planning and

fund raising, including printing and mailing, outside consultants' fees, and the like, as well as the salaries and employee benefits of the development director and his or her staff are included here. If such activities are carried out by the alumni/ae office or some other department, these expenses may be accumulated under the appropriate category.

General (79). Administrative or general expenses not attributable to any specific administrative department. Administrative salaries and employee benefits can be collected here if they are not charged to some other administrative department. If the school chooses not to break these personnel costs down by departments, this is the place to record them. Typically, most items under object of expenditure codes 60, 70, and 80 are charged here rather than to a specific administrative department. Employee benefits for all personnel are collected originally under department 79 category. When they are later allocated to the various functional expense categories (instruction, auxiliary services, plant, administration), the offsetting credit is posted to account 1-5-79-39. See sample journal entry 14 in Chapter 3, page 76.

Financial Aid (X-5-90-00). All expenses for financial aid, as described in Chapter 1, page 38, are included in this category.

Gifts Received (X-6-00-00)

All gifts received should be recorded as additions to the appropriate fund categories in the year received. Gifts applied to fund categories other than the category in which they were received should be clearly labeled as transfers and not be confused with gifts received in that fund category. One possible scheme for classifying sources of gifts received is shown in section C of Exhibit 2-1, page 45.

IV. Sample Chart of Accounts, Using the Proposed Coding System

The following sample chart of accounts, not presented in full detail, lists only a few accounts under each section. Our purpose is to show how the recommended account coding system would apply to a typical day school, without unduly complicating the illustration.

I. Balance Sheet Accounts

A. Operating fund - unrestricted

1. Assets

a. Cash

Cash - general account	1-1-11-00
Cash - savings account	1-1-12-00
Cash - payroll account	1-1-13-00
Petty cash	1-1-14-00

b. Accounts receivable

Accounts receivable - tuition	1-1-31-00
Accounts receivable - fees	1-1-32-00
Accounts receivable - miscellaneous	1-1-33-00
Allowance for uncollectable accounts	1-1-39-00

c. Inventories

Bookstore inventory	1-1-41-00
Athletic equipment inventory	1-1-42-00
Administrative supplies inventory	1-1-43-00

d. Prepaid expenses and deferred charges

Unexpired insurance	1-1-51-00
Deferred expense - other	1-1-52-00

e. Interfund balances - due from

Due from operating fund - restricted	1-1-92-00
Due from endowment funds	1-1-93-00

2. Liabilities and fund balance

a. Notes payable

Short-term notes payable	1-2-11-00
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b. Accounts payable

Accounts payable - trade	1-2-21-00
Accounts payable - food	1-2-22-00

2. Liabilities and fund balance (cont.)

c.	<u>Accrued liabilities - payroll</u>	
	Accrued wages and salaries payable	1-2-31-00
	Withholding tax - federal	1-2-32-00
	FICA payable	1-2-33-00
	Blue Cross/Blue Shield payable	1-2-34-00
d.	<u>Accrued liabilities - other</u>	
	Accrued interest payable	1-2-41-00
	Accrued expenses - other	1-2-42-00
e.	<u>Agency funds</u>	
	School newspaper	1-2-51-00
	Student snack bar	1-2-52-00
	French club	1-2-53-00
f.	<u>Unearned revenues and deferred credits</u>	
	Enrollment deposits	1-2-61-00
	Unearned income - other	1-2-62-00
g.	<u>Interfund balances - due to</u>	
	Due to plant fund - unexpended	1-2-95-00
h.	<u>Fund balance</u>	1-3-00-00

B. Operating fund - restricted

1.	<u>Assets</u>	
	Cash - general	2-1-11-00
	Cash - savings	2-1-12-00
	Temporary investments	2-1-21-00
2.	<u>Liabilities and fund balance</u>	
	Due to operating fund - unrestricted	2-2-91-00
	Fund balance	2-3-00-00

C. Endowment fund*

1.	<u>Assets</u>	
	Cash - savings account	3-1-11-00
	Investments - common stock	3-1-21-00
	Investments - bonds	3-1-22-00
	Investments - certificates of deposit	3-1-23-00
	Accrued interest and dividends receivable	3-1-34-00

*All endowment funds in this example are restricted.

C. Endowment fund (cont.)

2. Liabilities and fund balance

Due to operating fund - unrestricted	3-2-91-00
Fund balance - unexpended income	3-3-10-00
Fund balance - corpus - at cost	3-3-20-00
Fund balance - capital appreciation or depreciation	3-3-30-00

D. Plant fund - unexpended

1. Assets

Cash - savings account	5-1-11-00
Investments	5-1-21-00
Accrued interest receivable	5-1-34-00
Due from operating fund - unrestricted	5-1-91-00

2. Liabilities and fund balance

Fund balance	5-3-00-00
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E. Plant fund - invested

1. Assets

a. Land, buildings, and improvements

Land	6-1-61-00
Buildings	6-1-62-00
Building improvements	6-1-63-00

b. Equipment

Instructional equipment	6-1-71-00
Maintenance equipment	6-1-72-00
Vehicles	6-1-73-00
Furniture and fixtures	6-1-74-00

2. Liabilities and fund balance

Mortgage payable - National Bank	6-2-71-00
Mortgage payable - City Savings	6-2-72-00
Fund balance	6-3-00-00

II. Operating Accounts and Transfers

A. Operating fund - unrestricted

1. Revenues and gifts

Tuition revenue	1-4-11-00
Application fees	1-4-12-00
Fines and assessments	1-4-13-00

1. Revenues and gifts (cont.)

Yearbook	1-4-34-00
Athletic events	1-4-35-00
Trips and excursions	1-4-36-00
Lunchroom fees	1-4-42-00
Sales revenue - student bookstore	1-4-44-00
Transportation fees	1-4-47-00
Interest income earned	1-4-71-00
Miscellaneous income	1-4-91-00
Gifts received - alumni	1-6-10-00
Gifts received - parents	1-6-20-00
Gifts received - other	1-6-30-00

2. Expenses

a. Instruction

Personnel (10)

Instruction - salaries	1-5-10-11
Instruction - administrative salaries	1-5-10-13
Instruction - clerical salaries	1-5-10-14
Instruction - employee benefits applied	1-5-10-39

Fine Arts (11)

Materials and supplies	1-5-11-41
Subscriptions	1-5-11-61

English (12)

Materials and supplies	1-5-12-41
Subscriptions	1-5-12-61

History (13)

Materials and supplies	1-5-13-41
Subscriptions	1-5-13-61

Foreign language (14)

Materials and supplies	1-5-14-41
Subscriptions	1-5-14-61

Mathematics (15)

Materials and supplies	1-5-15-41
Subscriptions	1-5-15-61

Science (16)

Materials and supplies	1-5-16-41
Subscriptions	1-5-16-61

a. Instruction (cont.)

Athletics (26)

Materials and supplies	1-5-26-41
Equipment purchases charged to expense	1-5-26-54
Travel	1-5-26-77
Contracted services	1-5-26-81

Library (27)

Materials and supplies	1-5-27-41
Equipment purchases charged to expense	1-5-27-54
Subscriptions	1-5-27-61

Instructional administration (29)

Materials and supplies	1-5-29-41
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b. Student activities

Yearbook expense	1-5-32-00
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c. Auxiliary services

Lunchroom (42)

Salaries and wages	1-5-42-15
Payroll benefits applied	1-5-42-39
Food	1-5-42-44
Kitchen supplies	1-5-42-43

Student bookstore (44)

Salaries and wages	1-5-44-15
Payroll benefits applied	1-5-44-39
Cost of goods sold	1-5-44-45

Transportation (47)

Contracted services - bus rental	1-5-47-81
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d. Operation and maintenance of physical plant*

Salaries and wages	1-5-66-15
Payroll benefits applied	1-5-66-39
Maintenance supplies and materials	1-5-66-43
Electricity	1-5-66-51
Fuel	1-5-66-52
Provision for plant replacement, renewals, and special maintenance	1-5-66-55
Contracted services - maintenance	1-5-66-81

* A departmental breakdown is not maintained within the plant expense category. All expenses are included in one department, department 66.

2. Expenses (cont.)

e. General and administrative

School-wide (70)

Administrative salaries	1-5-70-13
Secretarial and clerical salaries	1-5-70-14
Payroll benefits applied	1-5-70-39

Head's office (71)

Travel and entertainment	1-5-71-77
Head's discretionary fund	1-5-71-82

Business office (73)

Supplies used	1-5-73-43
Professional fees	1-5-73-74
Equipment rentals	1-5-73-57

Alumni and development (75)

Supplies used	1-5-75-43
Printing costs	1-5-75-64
Advertising	1-5-75-66
Professional fees	1-5-75-74
Travel and entertainment	1-5-75-77

General (79)

FICA tax	1-5-79-21
Medical insurance	1-5-79-22
Retirement insurance - TIAA	1-5-79-26
Payroll benefits clearing account	1-5-79-39
Telephone	1-5-79-63
Postage and shipping	1-5-79-65
Insurance	1-5-79-71
Miscellaneous taxes	1-5-79-73
Commencement expense	1-5-79-88
Miscellaneous expense	1-5-79-89

f. Financial aid

Financial aid expense	1-5-90-91
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3. Transfers - in

Dividends and interest applied	1-7-21-00
Capital appreciation applied	1-7-22-00

4. Transfers - out

Transfer to endowment	1-7-10-30
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B. Operating fund - restricted

1. Revenues and gifts

Dividends and interest earned	2-4-71-00
Gifts received - alumni	2-6-10-00
Gifts received - parents	2-6-20-00
Gifts received - other	2-6-30-00

2. Expenses

Instructional salaries	2-5-10-11
Financial aid expense	2-5-90-91
Prizes and gifts	2-5-79-94

C. Endowment fund

Dividends and interest earned	3-4-71-00
Gifts received - alumni	3-6-10-00
Gifts received - parents	3-6-20-00
Gifts received - other	3-6-30-00
Transfers in - from operations	3-7-20-00
Transfers out - dividends and interest applied	3-7-11-00
Transfers out - capital appreciation applied	3-7-12-00

D. Plant fund - unexpended

Dividends and interest earned	5-4-71-00
Gifts received - alumni	5-6-10-00
Gifts received - parents	5-6-20-00
Gifts received - other	5-6-30-00
Transfers in - provision for plant replacement, renewal, and special maintenance	5-7-20-55
Transfers in - miscellaneous	5-7-20-00
Transfers out - investment in plant	5-7-10-60
Transfers out - paid on mortgage	5-7-10-70

E. Plant fund - invested

Transfers in - investment in plant	6-7-20-60
Transfers in - paid on mortgage	6-7-20-70

Chapter 3

SAMPLE JOURNAL ENTRIES

In the normal course of operations, individual financial transactions can involve several accounts and more than one fund group. The inter-relationship among accounts, however, should not prevent maintaining each distinct fund as a balanced accounting entity. Because the accounting principles governing the financial activities of independent schools require accurate recording of data, we include this chapter to illustrate original entries for many typical transactions.

The sample entries that follow are based on the chart of accounts and coding structure described in Chapter 2. Many of the transactions involving cash receipts and disbursements would probably be recorded initially in a cash receipts or disbursements journal. They are shown here in general journal format for ease of presentation and understanding. Noncash entries and closing and adjusting entries should always be recorded first in the general journal in the format presented below.

<u>Account No.</u>	<u>Description</u>	<u>Dr.</u>	<u>Cr.</u>
1. <u>Tuition billing.</u> Bills of \$2,000 each are issued to 250 students for the school year beginning September 19xx.			
1-1-31-00	Accounts receivable - students	\$500,000	
1-4-11-00	Tuition revenues		500,000
	<u>To record tuition revenue for the year.</u>		
2. <u>Tuition collection.</u> Checks totaling \$120,000 for tuition are received.			
1-1-11-00	Cash - operating	\$120,000	
1-1-31-00	Accounts receivable - students		120,000
	<u>To record tuition collections.</u>		

<u>Account No.</u>	<u>Description</u>	<u>Dr.</u>	<u>Cr.</u>
3. <u>Gifts received.</u> A gift for current operations (\$75) and a gift restricted for scholarship use (\$500) are received from parents.			
1-1-11-00	Cash - operating - unrestricted	\$75	
2-1-11-00	Cash - restricted	500	
1-6-20-00	Gifts - unrestricted - parents		75
2-6-20-00	Gifts - restricted - parents		500
	<u>To record gifts received.</u>		
4. <u>Endowment income.</u> Dividends of \$750 are received from 100 shares of ABC Corporation. These shares are part of the pooled investment portfolio of the endowment funds group and are restricted in use.			
4-1-11-00	Cash - restricted endowment	\$750	
4-4-79-00	Pooled investment income - undistributed*		750
	<u>To record receipt of ABC Corporation dividend.</u>		
5. <u>Capital appreciation applied to operations.</u> A transfer of \$1,000 is made from unrestricted endowment to operations representing a portion of capital gains considered expendable under the total-return concept.			
3-7-10-00	Transfers out - unrestricted endowment	\$1,000	
3-1-11-00	Cash - unrestricted endowment		1,000
1-1-11-00	Cash - operating	\$1,000	
1-7-20-00	Transfers in - operations		1,000
	<u>To record "total return" applied to operations.</u>		
6. <u>Invoice - cash basis for recording expense.</u> A bill of \$138 is paid for the printing of a brochure used by the admissions office.			
1-5-72-68	Admissions office - special publications	\$138	
1-1-11-00	Cash - operating		138
	<u>To record admissions office expense paid in cash.</u>		

*Earnings from pooled investments are recorded originally in the restricted endowment funds grouping before they are distributed to the various funds in the pool. See entry 15, below, for an illustration of distribution of income from pooled investments.

<u>Account No.</u>	<u>Description</u>	<u>Dr.</u>	<u>Cr.</u>
7. <u>Invoice - accrual basis for recording expense.</u> A bill for boiler repair received during the last week in June will not be paid until the next fiscal year, i.e., July. The following entry sets up the account payable. (This procedure may be used throughout the year for full accrual accounting or only at year-end to establish the accounts payable liability.)			
1-5-61-81	Buildings - contracted services	\$236	
1-2-20-00	Trade accounts payable		236
	<u>To set up accounts payable as of June 30.</u>		
8. <u>Invoice - accrual basis for recording disbursement.</u> The bill for boiler repairs recorded in June is paid in July.			
1-2-20-00	Trade accounts payable	\$236	
1-1-11-00	Cash - operating		236
	<u>To pay bill set up as accounts payable at June 30.</u>		
9. <u>Purchase of equipment</u>			
a. The school buys equipment that is capitalized.			
6-1-70-00	Equipment	\$5,000	
5-7-10-00	Transfers out - plant - unexpended	5,000	
6-7-20-00	Transfers in - investment in plant		5,000
5-1-11-00	Cash - plant funds unexpended		5,000
	<u>To record purchase of equipment.</u>		
b. The school buys equipment that is charged to expense, e.g., library book replacements.			
1-5-27-54	Library - equipment purchases charged to expense	\$300	
1-1-11-00	Cash - operating		300
	<u>To record expense for library books purchased.</u>		
10. <u>Retirement of plant assets.</u> Equipment that originally cost \$2,000 is scrapped.			
6-3-00-00	Fund balance - investment in plant	\$2,000	
6-1-70-00	Equipment		2,000
	<u>To scrap equipment no longer in use.</u>		

<u>Account No.</u>	<u>Description</u>	<u>Dr.</u>	<u>Cr.</u>
11. <u>Provision for plant replacement, renewal, and special maintenance</u>			
1-5-66-55	Provision for plant replacement, renewal, and special maintenance	\$25,000	
1-1-11-00	Cash - operating		25,000
5-1-11-00	Cash - plant funds	\$25,000	
5-7-20-00	Transfers in - plant funds unexpended		25,000
<u>To record the funding of "PPRRSM" for the year.</u>			

12. Financial aid

a. Financial aid totaling \$41,000 is granted.

1-5-90-91	Financial aid - tuition	\$41,000	
1-1-31-00	Accounts receivable - students		41,000
<u>To record financial aid for the year.</u>			

b. At year-end, \$16,000 of restricted funds is applied against the financial aid of \$41,000 already granted.

2-5-90-91	Financial aid - tuition	\$16,000	
2-1-11-00	Cash - restricted		16,000
1-1-11-00	Cash - operating	\$16,000	
1-5-90-91	Financial aid - tuition		16,000
<u>To record the application of restricted funds to financial aid.</u>			

13. Payroll. This simplified example illustrates the recording of a payroll. As can be seen, it consists of distributing salaries to the functional expense accounts, recording employee benefits expenses, disbursing cash, and posting the liability accounts for payroll withholdings. This payroll covers one faculty member, one administrator (admissions office), and a building custodian. The school pays all hospitalization insurance and matches pension contributions.

a. The payroll journal

1-5-10-11	Instruction - faculty salaries	\$1,000	
1-5-72-13	Administration - admissions salaries	750	
1-5-62-15	Plant - cleaning - salaries and wages	500	
1-1-11-00	Cash - operating		1,690
1-2-31-00	Taxes payable - FICA		130
1-2-32-00	Taxes withheld - state income tax		50
1-2-33-00	Taxes withheld - federal income tax		300
1-2-34-00	Retirement insurance payable		80
<u>To record the payroll of September 19xx.</u>			

<u>Account No.</u>	<u>Description</u>	<u>Dr.</u>	<u>Cr.</u>
13. <u>Payroll (cont.)</u>			
b. Employee benefits expense for the payroll			
1-5-79-21	Employee benefits - FICA tax	\$130	
1-5-79-24	Employee benefits - medical and hospital insurance	60	
1-5-79-26	Employee benefits - retirement insurance	80	
1-2-31-00	Taxes payable - FICA		130
1-2-34-00	Retirement insurance payable		80
1-2-35-00	Accrued medical and hospital insurance		60
<u>To accrue employee benefits for the payroll of September 19xx.</u>			
c. Payment of liability for employee benefits accrued			
1-2-35-00	Accrued medical and hospital insurance	60	
1-1-11-00	Cash - operating		60
14. <u>Distributing employee benefits</u>			
1-5-10-39	Instruction - employee benefits applied	\$120	
1-5-72-39	Administration-admissions - employee benefits applied	90	
1-5-62-39	Operation and maintenance of plant-cleaning - employee benefits applied	60	
1-5-79-39	Employee benefits applied		270*
<u>To distribute employee benefits to the functional expense categories based on salaries paid.</u>			

*In this simplified example, the \$270 of employee benefits expense is distributed to the departments in proportion to the salaries of each department.

<u>Department</u>	<u>Salaries</u>	<u>Portion of Total</u>	<u>Portion of Employee Benefits</u>
Instruction	\$1,000	4/9	\$120
Admissions	750	1/3	90
Cleaning	500	2/9	60
Total	<u>\$2,250</u>	<u>1</u>	<u>\$270</u>

As employee benefits are distributed, account 79-39 accumulates total credits equal to the sum of all the debits for employee benefits charged to accounts 79-21 through 79-38. Thus, benefits charged to department 79 eventually zero out, with the benefits being distributed to each other department based on salaries and wages paid in that department.

<u>Account No.</u>	<u>Description</u>	<u>Dr.</u>	<u>Cr.</u>
15.	<u>Distribution of accumulated pooled investment income.</u> This journal entry illustrates the annual distribution of pooled investment income to the revenues of the funds that participate in the pool. For purposes of illustration, restricted fund A has a 10% interest, restricted fund B a 15% interest, and the unrestricted endowment fund a 75% interest in the pool.		
4-4-79-00	Pooled investment income - undistributed*	\$10,000	
4-1-11-00	Cash - restricted endowment		10,000
2-1-11-00	Cash - restricted	2,500	
2-4-70-00	Dividends and interest earned - restricted operating fund A		1,000
2-4-70-00	Dividends and interest earned - restricted operating fund B		1,500
3-1-11-00	Cash - unrestricted endowment	7,500	
3-4-70-00	Dividends and interest earned - unrestricted endowment fund		7,500
	<u>To record annual distribution of pooled investment income.</u>		
16.	<u>Provision for uncollectable accounts</u>		
a.	Operating expenses are charged for the estimated cost of uncollectable accounts.		
1-5-79-76	Provision for uncollectable accounts	\$1,000	
1-1-39-00	Allowance for uncollectable accounts		1,000
	<u>To provide for expected uncollectable student accounts.</u>		
b.	Actual accounts that become uncollectable are charged off.		
1-1-39-00	Allowance for uncollectable accounts	\$250	
1-1-31-00	Accounts receivable - students		250
	<u>To record accounts written off as uncollectable.</u>		
c.	Accounts previously written off are recovered.		
1-1-11-00	Cash - operating	\$100	
1-1-39-00	Allowance for uncollectable accounts		100
	<u>To record amounts received on accounts previously written off.</u>		

*For accounting purposes, pooled investment income is recorded in the restricted endowment funds grouping before being distributed to the various funds that participate in the pool.

<u>Account No.</u>	<u>Description</u>	<u>Dr.</u>	<u>Cr.</u>
17. <u>Merchandise held for sale</u>			
a. The school purchases merchandise for resale.			
1-1-40-00	Inventory - student store	\$500	
1-1-11-00	Cash - operating		500
	<u>To record merchandise purchased for the student store.</u>		
b. Based on an inventory at year-end, it is determined that \$10,000 worth of merchandise was sold during the year.			
1-5-43-45	Student store - cost of goods sold	\$10,000	
1-1-40-00	Inventory - student store		10,000
	<u>To record cost of goods sold in the student store.</u>		
18. <u>Tuition deposits received in advance</u>			
1-1-11-00	Cash - operating	\$10,000	
1-1-26-00	Unearned revenues		10,000
	<u>To record the receipts of a \$200 tuition deposit from each of 50 students, applicable to next year's tuition.</u>		

Chapter 4

FINANCIAL STATEMENTS: THE SCHOOL'S ANNUAL FINANCIAL REPORT

Once the financial activities of the school for the year have been properly recorded in the books of account, the information must be summarized in a format that clearly presents the financial position of the school at the end of the year and the results of the school's operations during the year.

In this chapter, we give sample financial statements and related supporting schedules for a hypothetical independent school, following the accounting and reporting principles described in Chapters 1 and 2.

The purpose of these illustrative statements is to indicate a general format for the minimum information recommended, not to provide an exact example. Good judgment should still be exercised in order to strike a proper balance between conformity with other independent schools and full and meaningful disclosure of the financial situation of a particular school. Naturally, items that are not applicable cannot be reported and may thus be omitted. On the other hand, if a school wishes to report in greater detail than we suggest here, it may expand any of the statement classifications or provide additional supporting schedules to present such detail.

Financial statements illustrated in this chapter are

Statement of Financial Position (Exhibit 4-1)

Statement of Revenues, Expenses, and Other Changes
in Fund Balances (Exhibit 4-2).

Examples of typical kinds of notes required to achieve fuller disclosure are given in Exhibit 4-3.

In addition, the following supporting schedules are illustrated.

Schedule of Invested Funds (Exhibit 4-4)

Schedule of Gifts Received (Exhibit 4-5)

Schedule of Interfund Balances (Exhibit 4-6)

Reconciliation of Expenses by Function and
by Object of Expenditure (Exhibit 4-7)

This set of statements and supporting schedules constitutes the minimum that a school should prepare at the end of each fiscal year. Additional statements and/or schedules, such as a more detailed schedule of operating expenses or operating revenues, may be prepared if they will add significantly to an understanding of the school's financial condition and the results of its operations. The publication of additional statements or schedules should, however, be approached with caution, since providing too much information can inhibit examination and understanding just as much as providing too little information.

Condensed statements. Since many trustees and others associated with independent schools are not knowledgeable about finance or accounting, they may find it difficult to extract the essential messages from the annual financial report of the school. To address this need, many schools prepare supplementary condensed or summarized financial statements, using nontechnical language. Examples of such an approach are shown in Exhibits 4-8 and 4-9. We encourage each school to consider preparing and distributing simplified statements like these as a way of promoting broader understanding of the school's financial situation among the nonfinancially oriented trustees and friends of the school.

Exhibit 4-1

The Independent School
Statement of Financial Position
Year ended June 30, 1975

	Year ended June 30, 1975						All funds combined, year ended June 30, 1974
	Operating funds		Endowment funds		Plant funds		All funds combined
	Unrestricted	Restricted	Unrestricted	Restricted	Unexpended	Invested	
<u>Assets</u>							
Cash	\$ 12,000	\$ 1,000	\$ 10,000	\$ 19,000	\$63,000	\$	\$ 105,000
Investments - at market (see Exh. 4-4)	35,000	7,000	313,000	100,000	10,000		465,000
Accounts receivable	34,000						34,000
Inventories - at cost	7,000						7,000
Land and buildings - at cost						2,175,000	2,175,000
Equipment - at cost						123,000	123,000
Other assets	17,000						17,000
Subtotal	105,000	8,000	323,000	119,000	73,000	2,298,000	
Interfund balances - net (see Exh. 4-6)	(12,000)	19,000	7,000		2,000	(16,000)	
TOTAL	\$ 93,000	\$27,000	\$330,000	\$119,000	\$75,000	\$2,282,000	\$2,926,000
<u>Liabilities</u>							
Accounts payable	\$ 9,000	\$	\$	\$	\$	\$	9,000
Accrued liabilities	4,000						4,000
Unearned revenues	86,000						86,000
Mortgages payable (see Exh. 4-3, n. 2)						131,000	131,000
Total liabilities	99,000					131,000	230,000
Fund balances	(6,000)	27,000	330,000	119,000	75,000	2,151,000	2,622,000
TOTAL	\$ 93,000	\$27,000	\$330,000	\$119,000	\$75,000	\$2,282,000	\$2,926,000

See related notes in Exhibit 4-3.

Exhibit 4-2

The Independent School
Statement of Revenues, Expenses, and Other Changes in Fund Balances
Year ended June 30, 1975

	Year ended June 30, 1975						All funds combined, year ended June 30, 1974
	Operating funds		Endowment funds		Plant funds		All funds combined
	Unrestricted	Restricted	Unrestricted	Restricted	Unexpended	Invested	
Revenues							
Tuition and fees	\$ 910,000	\$	\$	\$	\$	\$	\$ 910,000
Dividends and interest earned	2,000		15,000	5,000	6,000		28,000
Auxiliary services	25,000						25,000
Other (see Exh. 4-3, n. 5)	112,000						112,000
TOTAL	1,049,000		15,000	5,000	6,000		1,075,000
							1,063,000
Expenses (see Exh. 4-7)							
Instruction and student activities	598,000	29,000					627,000
Auxiliary services	94,000	6,000		1,000			101,000
Operation and maintenance of plant	180,000	7,000					187,000
General and administrative	130,000	2,000	5,000				137,000
Other	115,000	--					115,000
Financial aid	--	37,000					37,000
TOTAL	1,117,000	81,000	5,000	1,000			1,204,000
							1,141,000
Surplus (deficit) before gifts	(68,000)	(81,000)	10,000	4,000	6,000		(129,000)
Gifts received (see Exh. 4-5)	56,000	70,000	46,000	30,000	2,000		204,000
Surplus (deficit) after gifts	(12,000)	(11,000)	56,000	34,000	8,000		(75,000)
							(3,000)
Other changes in fund balances							
Interfund transfers							
Dividends and interest applied	13,000	6,000	(13,000)	(6,000)			
Capital appreciation applied	3,000	1,000	(3,000)	(1,000)			
Mortgage principal paid					(52,000)	52,000	
Purchase plant assets							
Buildings					(25,000)	25,000	
Equipment					(24,000)	24,000	
Provision for PRRSM*					50,000		50,000
Plant assets retired							
Buildings						(20,000)	(20,000)
Equipment						(20,000)	(20,000)
Change in market value of investments	(2,000)	(1,000)	(6,000)	(2,000)			(11,000)
TOTAL	14,000	6,000	(22,000)	(9,000)	(51,000)	61,000	(1,000)
							12,000
NET CHANGE FOR THE YEAR	2,000	(5,000)	34,000	25,000	(43,000)	61,000	74,000
							9,000
FUND BALANCE - BEGINNING OF YEAR	(8,000)	32,000	296,000	94,000	118,000	2,090,000	2,622,000
							2,613,000
FUND BALANCE - END OF YEAR	\$ (6,000)	\$27,000	\$330,000	\$119,000	\$ 75,000	\$2,151,000	\$2,622,000

* Provision for Plant Replacement, Renewal, and Special Maintenance. See Chapter 1, pages 35-38, for an explanation of this item. See Chapter 3, entry 11, page 75, for an illustration of the bookkeeping procedure.

See related notes in Exhibit 4-3.

Exhibit 4-3

Notes to the Financial Statements

1. Accounting policies. Investments are valued at estimated market value. The school uses the "total return" method of determining investment income available for operations. Inventories are valued by using the First-In, First-Out (FIFO) system. Property assets are recorded at acquisition cost. Property assets are not depreciated. In accordance with recommended accounting practices for independent schools, provision is made among the operating expenses for the average annual expenditure related to plant replacement, renewal, and special maintenance. Pledges are not recorded until they are paid.

2. Long-term debt

	<u>1975</u>	<u>1974</u>
Mortgage notes payable		
Federal Savings Bank, 7-1/2% demand	\$ 6,000	\$ 8,000
Federal Savings Bank, 8-1/4% (1974, 8-1/2%), demand first mortgage	115,000	85,000
Paul Martin, no interest, \$50,000 payable on October 1, 1974, and \$30,000 payable on April 1, 1975, second mortgage		80,000
Other note payable - James Ashe, 4%, demand	10,000	10,000
Total	\$131,000	\$183,000

The 7-1/2% mortgage note payable is collateralized by the Hartford Building. The first and second mortgage notes payable are collateralized by property located at 40-44 Maple Street. Payment of Paul Martin's mortgage note was made with (1) the proceeds from the increase of \$30,000 in the Federal Savings Bank first mortgage note payable, and (2) Martin Property Fund cash of \$50,000.

3. Pension plans. All school employees are eligible for retirement benefits under the federal Social Security system. Teachers are also covered by TIAA/CREF, which is funded by the school. Pension expense for 1975 was \$26,000.

4. Unrecorded contingent assets. The school has uncollected pledges receivable under the capital gifts program totaling \$175,000, which are due over a three-year period. These pledges are not recorded in the financial statements because they do not represent legal obligations. The school is a beneficiary under several charitable remainder trusts. The amount the school will ultimately receive from such trusts cannot reasonably be determined at this time.

5. Detail of other revenues

	<u>1975</u>	<u>1974</u>
Summer school	\$ 86,000	\$ 85,000
Rentals	19,000	20,000
Sale of equipment	3,000	2,000
Miscellaneous	4,000	6,000
Total	<u>\$112,000</u>	<u>\$113,000</u>

Exhibit 4-4

The Independent School
Schedule of Invested Funds
Year ended June 30, 1975

<u>Invested funds</u>	<u>1975</u>		<u>1974</u>		<u>Dividends & interest</u>	
	<u>Market value</u>	<u>Cost</u>	<u>Market value</u>	<u>Cost</u>	<u>1975</u>	<u>1974</u>
Government securities	\$ 30,000	\$ 30,000	\$ 30,000	\$ 30,000	\$ 2,000	\$ 2,000
Corporate bonds	45,000	50,000	48,000	45,000	4,000	4,000
Preferred stock	50,000	60,000	54,000	60,000	3,000	3,000
Common stock	<u>340,000</u>	<u>181,000</u>	<u>284,000</u>	<u>156,000</u>	<u>12,000</u>	<u>9,000</u>
Subtotal - investments	465,000	321,000	416,000	291,000	21,000	18,000
Cash invested*	<u>89,000</u>	<u>89,000</u>	<u>114,000</u>	<u>114,000</u>	<u>7,000</u>	<u>8,000</u>
TOTAL	<u><u>\$554,000</u></u>	<u><u>\$410,000</u></u>	<u><u>\$530,000</u></u>	<u><u>\$405,000</u></u>	<u><u>\$28,000</u></u>	<u><u>\$26,000</u></u>

* Included with cash in the statement of financial position.

Exhibit 4-5

The Independent School
Schedule of Gifts Received
Year ended June 30, 1975

Sources of gifts	Uses of gifts						All funds combined, year ended June 30, 1975	All funds combined, year ended June 30, 1974
	Operations		Endowment		Plant			
	Unre- stricted	Restricted	Unre- stricted	Restricted	Unex- pended	Invested		
Alumni	\$10,000	\$ 5,000	\$25,000	\$	\$	\$	\$ 40,000	\$13,000
Parents	34,000						34,000	22,000
Trustees		25,000	5,000				30,000	20,000
Grandparents	12,000	18,000					30,000	
Friends		22,000	16,000	10,000	2,000		50,000	20,000
Corporations				5,000			5,000	
Foundations				15,000			15,000	
TOTAL - Year ended 6/30/75	<u>\$56,000</u>	<u>\$70,000</u>	<u>\$46,000</u>	<u>\$30,000</u>	<u>\$2,000</u>	\$	<u>\$204,000</u>	<u>\$75,000</u>
TOTAL - Year ended 6/30/74	<u>\$39,000</u>	<u>\$35,000</u>	<u>\$ 1,000</u>	\$	\$	\$	<u>\$ 75,000</u>	

Exhibit 4-6

The Independent School
Schedule of Interfund Balances
Year ended June 30, 1975

	Due to						
	Operating		Endowment		Plant		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	<u>Unrestricted</u>	<u>Restricted</u>	<u>Unrestricted</u>	<u>Restricted</u>	<u>Unexpended</u>	<u>Invested</u>	<u>Total</u>
Due from							
Operating - unrestricted	\$	\$19,000	\$	\$	\$2,000	\$	\$ 21,000
Operating - restricted							
Endowment - unrestricted							
Endowment - restricted							
Plant - unexpended							
Plant - invested	<u>9,000</u>	<u></u>	<u>7,000</u>	<u></u>	<u></u>	<u></u>	<u>16,000</u>
Total due from	9,000	19,000	7,000		2,000		37,000
Total due to (column 7)	<u>(21,000)</u>	<u></u>	<u></u>	<u></u>	<u></u>	<u>(16,000)</u>	<u>(37,000)</u>
Net interfund balances							
Due from/(due to)	<u>\$ (12,000)</u>	<u>\$19,000</u>	<u>\$7,000</u>		<u>\$2,000</u>	<u>\$ (16,000)</u>	

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Exhibit 4-7

The Independent School
Reconciliation of Expenses by Function and by Object of Expenditure
Year ended June 30, 1975

<u>Object of expenditure</u>	<u>Function</u>					<u>Total</u>
	<u>Instruction and student activities</u>	<u>Auxiliary services</u>	<u>Operation and maintenance of plant</u>	<u>General and administrative</u>	<u>Financial aid and other</u>	
Salaries and wages	\$442,000	\$ 19,000	\$ 76,000	\$ 95,000	\$ 49,000	\$ 681,000
Employee benefits	88,000	4,000	15,000	19,000	10,000	136,000
Materials and supplies	68,000	70,000		8,000	31,000	177,000
Utilities and other plant expenses	4,000		96,000		9,000	109,000
Information and communications	10,000			9,000		19,000
General expenses				6,000	5,000	11,000
Other expenses	15,000	8,000			11,000	34,000
Financial aid					37,000	37,000
TOTAL	<u>\$627,000</u>	<u>\$101,000</u>	<u>\$187,000</u>	<u>\$137,000</u>	<u>\$152,000</u>	<u>\$1,204,000</u>

Exhibit 4-8

The Independent School
Condensed Statement of Financial Position
Year ended June 30, 1975

	How much we own (Assets)	less	How much we owe (Liabilities)	equals	Our net worth (Fund balance)
<u>For each fund group</u>					
Operating funds - unrestricted	\$ 114,000		\$120,000		\$ (6,000)
Operating funds - restricted	27,000		0		27,000
Endowment funds - unrestricted	330,000		0		330,000
Endowment funds - restricted	119,000		0		119,000
Plant funds - unexpended	75,000		0		75,000
Plant funds - investment in plant	2,298,000		147,000		2,151,000
Less bookkeeping adjustments	(37,000)		(37,000)		0
For the whole school combined	\$2,926,000		\$230,000		\$2,696,000

Notes

Restricted funds are those established by a donor for a specific purpose.

Endowment funds represent money set aside for investment. The income earned each year by endowment funds goes for school operations.

Plant funds - unexpended represents money set aside for future purchases of plant assets such as equipment or vehicles.

Exhibit 4-9

The Independent School
Condensed Statement of Operations and Other Changes in Fund Balances
Years ended June 30, 1975 and 1974

	Fund groups			For the school as a whole	
	Operating funds	Endowment funds	Plant funds	All funds combined, 1975	All funds combined, 1974
Operating revenues	\$1,049,000	\$ 20,000	\$ 6,000	\$1,075,000	\$1,063,000
Operating expenses	<u>1,198,000</u>	<u>6,000</u>		<u>1,204,000</u>	<u>1,141,000</u>
Difference, before considering gifts	(149,000)	14,000	6,000	(129,000) *	(78,000) *
Gifts received	<u>126,000</u>	<u>76,000</u>	<u>2,000</u>	<u>204,000</u>	<u>75,000</u>
Difference, after gifts	(23,000)	90,000	8,000	75,000	(3,000)
Transfers between funds	23,000	(23,000)			
Other changes - net	<u>(3,000)</u>	<u>(8,000)</u>	<u>10,000</u>	<u>(1,000)</u>	<u>12,000</u>
Net change for the year	(3,000)	59,000	18,000	74,000	9,000
plus "Net worth," beginning of year	<u>24,000</u>	<u>390,000</u>	<u>2,208,000</u>	<u>2,622,000</u>	<u>2,613,000</u>
equals "Net worth," end of year	<u>\$ 21,000</u>	<u>\$449,000</u>	<u>\$2,226,000</u>	<u>\$2,696,000</u>	<u>\$2,622,000</u>

*We believe it is important to call your attention to the fact that before considering gifts, the school operated at a deficit of \$129,000 this year and \$78,000 last year. In short, operating revenues do not cover the cost of our excellent academic program. We rely each year on the generous support of our many friends to meet this deficit. Without such continuing support, we could not offer the same academic program.

Chapter 5

DEALING WITH THE INDEPENDENT CERTIFIED PUBLIC ACCOUNTANT

As noted in Chapter 1, we strongly recommend that every independent school have an independent certified public accountant (CPA) conduct an annual audit of its financial records. This audit should be of sufficient scope to allow the CPA to express an unqualified opinion about the school's financial position and the results of its operations.

A few schools engage a CPA to help prepare the annual financial statements on only an unaudited basis. We strongly discourage this practice because an annual audit is imperative in helping the school's trustees meet their fiduciary responsibilities.

I. Services Provided by the CPA

Although the annual audit is the principal service provided by the independent auditor, he or she can also provide other services to the school. Following is a summary of the range of services that the CPA can offer the school.

A. The Annual Audit

The primary service the CPA provides is the annual examination of the school's financial records. This examination should be conducted in accordance with the generally accepted auditing standards set by the American Institute of Certified Public Accountants. The annual audit involves an analytic review of the school's operations, review and testing of the school's internal control systems, tests for accuracy of the accounting records, and verification of significant asset and liability balances. When the annual audit is completed, the auditor prepares a letter expres-

sing an opinion on the financial statements of the school.

In addition to the auditor's opinion letter, the trustees should also receive each year, as a result of the audit, a commentary by the auditor on the overall financial management practices of the school, with suggested improvements. Such a commentary is typically called a "management letter." Any auditor who fails to provide a management letter each year is not giving the school the full service to which it is entitled.

E. Bookkeeping Services

The CPA can take responsibility for maintaining the basic books of account for the school, which includes recording all transactions and all necessary adjusting entries in the books of original entry and maintaining the general ledger.

Providing basic bookkeeping and accounting services is called "write up" work. Individual CPA's and small accounting firms are usually more interested in providing such services than larger firms. Using the "write up" services of a local CPA may be a cost-effective step for schools that cannot afford a full-time accounting person on the staff.

When a CPA is engaged to provide basic bookkeeping services, that person or firm is prohibited by the canons of professional ethics from also auditing the school's financial statements.

C. Periodic Preparation or Review of Financial Statements

If the financial record-keeping is done by someone on the staff of the school who is a bookkeeper but not an accountant, the CPA can take responsibility for preparing monthly or quarterly financial statements. Such interim financial statements are of great value to the head of the

school and the finance committee of the trustees in reviewing and monitoring results of operations as the year progresses. In constructing interim financial statements, the CPA first reviews the books and records to make sure that all significant items are properly reflected.

Even if the school's business manager is responsible for preparing the interim financial statements, it is often desirable to have the CPA review them quarterly or semiannually as an independent check on their accuracy for the trustees. Such periodic reviews by the CPA also ensure that no accounting or reporting problems arise that might cause delay or other difficulties in the year-end audit.

D. Consulting and Financial Advisory Services

The CPA can undertake specific consulting projects on improving the basic accounting system, the reporting system, financial controls, budgeting and financial planning systems, and systems for managing such items as cash, accounts receivable, and accounts payable. The CPA's expertise as a financial professional and his or her familiarity with the school offer significant advantages when the school is thinking about using a consultant.

The CPA should also always be available to answer specific accounting questions, to offer suggestions on how to conduct the administrative aspects of the school's operations, and to give advice on managing the school's financial resources and obligations. Such advice and counsel are part of the basic service rendered by the CPA.

The CPA, as well as the school's legal counsel, can help the school monitor its compliance with the provisions of the Employee Retirement Income Security Act (ERISA). Various forms must be filed under this act.

For schools that have pension plans, compliance in this area can be troublesome unless an expert in the field is consulted.

E. Taxation Services

Even though the independent school is exempt from income and valuation taxes, there are still many ways in which the CPA can be helpful in this area.

For example, the CPA, as well as the school's legal counsel, can help prepare the annual federal information return (Form 990) for the school. Similarly, the CPA can determine whether the school is required to file the federal tax return for unrelated trade or business taxable income (Form 990-T) and help prepare the return if it must be filed.

The CPA can also help prepare or review federal, state, and local payroll tax returns for the school, give advice on compliance with state sales or use tax regulations, and help the school in complying with local property tax regulations.

II. The Auditor's Opinion

The annual audit should be of sufficient scope to allow the auditor to express an unqualified opinion about the school's financial statements. Exhibit 5-1, opposite, illustrates the preferred form for an unqualified opinion for an independent school.

Three aspects of this "standard" opinion are worthy of particular mention.

First, the opinion should refer to fair presentation of the financial position of the school as a whole, not just to the financial position of each of the fund groupings. We do not recommend that the opinion refer to the financial position of each of the fund groupings within the school.

Exhibit 5-1

Auditor's Opinion Letter

JOHN DOE AND COMPANY
Certified Public Accountants
City, State

August 15, 1976

Board of Trustees
The Independent School
City, State

We have examined the statement of financial position of The Independent School as of June 30, 1976, and the related statement of revenues, expenses, and other changes in fund balances for the year then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We previously examined and reported upon the financial statements for the year ended June 30, 1975.

In our opinion, the financial statements mentioned above present fairly the financial position of The Independent School as of June 30, 1976 and 1975 and the results of its operations and other changes in fund balances for the years then ended, in conformity with generally accepted accounting principles for educational institutions applied on a consistent basis.

John Doe and Company
Certified Public Accountants

Since the primary entity of interest to the reader of the financial statements is the school as a whole, the auditor should express an opinion about the reported financial position of the school as a whole.

Second, the opinion should refer to fair presentation of the results of operations for the school, not just to fair presentation of revenues, expenditures, and transfers of operating funds and other changes in fund balances. We recommend specific mention of the results of operations for the school. When the auditor's opinion refers only to fair presentation of additions to and deductions from fund balances of separate fund groupings, it is not clear that the combined amounts present fairly the operating results for the school as a whole.

Third, the opinion should state that the financial statements have been presented in accordance with generally accepted accounting principles for educational institutions. There are significant areas in which accounting for educational institutions does not conform to accounting for commercial enterprises. The main areas of difference are the use of fund accounting, nonrecognition of depreciation, and the optional use of the market method for valuing investment securities. Because school accounting principles do differ in some significant ways from business accounting principles, it is important that the reader of the financial statements be made aware that it is school accounting principles that are being followed. For this reason, we recommend that the reference in the auditor's opinion to "generally accepted accounting principles" include the modifying phrase "for educational institutions." This manual can serve as a guide to interpreting generally accepted accounting principles for educational institutions as they apply to independent schools.

III. The Audit and Internal Control

A sound system of internal control is necessary to ensure that the school carries out fully its stewardship responsibilities for the funds entrusted to it. A sound system of internal control also makes it easier to complete the annual audit in an orderly and timely fashion.

An adequate system of internal control involves a planned organization structure and the specific methods and procedures used by the school to safeguard its assets, to check the accuracy and reliability of its accounting data, to promote operational efficiency, and to encourage adherence to prescribed policies. The following elements are fundamental to a comprehensive system of internal control.

A clear-cut plan that provides for definite placement of responsibility and for specific lines of authority

Division of duties, wherever practicable, between authorization and record-keeping, so that the activities of one employee act as a check on those of another

Forms, documents, and procedures that provide from control and for proper approvals

Auditing for compliance with policies and procedures, particularly those relating to transactions reflected in the books and to reports based on such transactions

IV. Selecting a CPA

The school should keep three basic considerations in mind in selecting an independent auditor: quality of the audit work, level of personal attention and service, and cost of service.

A. Quality of Audit Work

As far as quality is concerned, the school may assume that any

certified public accountant is competent to provide accounting and auditing services that fully meet the high standards of the profession. In evaluating the relative strengths of local accounting firms, the school may solicit recommendations from the school's bankers, from trustees who are familiar with the local business community, and from other independent schools. Attorneys are also often able to recommend accounting firms with which they have worked in the community. It is also entirely appropriate to ask a CPA to give current clients as references.

Another favorable sign is the CPA who has other independent schools as clients. While this cannot always be the case, and is not a requirement, it is one good way of ensuring that the CPA is keeping up with school accounting and auditing issues.

B. Personal Attention and Service

Regarding the level of personal attention devoted to the school, it is safe to say that, the larger the accounting firm, the less likely the school is to be a significant client. When the school is not a significant client, in terms of the firm's annual revenues, it is also less likely that the same people in the firm will continue to be assigned to the job or that the firm will make it a point to visit the school frequently and review the accounting records more than once a year.

The advantages of dealing with a large accounting firm can be significant for many schools, in terms of more wide-ranging staff experience, access to national expertise in special problem areas, and widespread recognition that the audit work is of the highest quality. Nevertheless, many schools prefer to work with a smaller auditing firm because they feel that the level of personal attention is higher.

Whatever the size of the auditing firm, the school should expect the firm to provide a high level of personal attention and service.

C. Cost of Service

The large accounting firms charge higher rates per hour, which usually translate into a higher overall audit fee. As of mid-1976, partners of the largest international firms charged about \$85 per hour, whereas partners of local firms charged about \$40 per hour. Below the partner level, the differences are not so dramatic. Staff accountants in large firms cost about \$20-25 per hour.

In selecting a CPA, cost should not be the sole criterion. Sometimes the CPA quotes a low fee because he or she does not plan to spend much time at the school. Sometimes the CPA quotes a low fee because he or she is more interested in the "contacts" represented by the school's board of trustees than in the school itself. And sometimes a low fee is quoted in the hope that the price can be raised substantially in later years, once a relationship has been established. Cost is an important factor, but it is only one of many aspects to be considered in selecting an auditor.

Smaller accounting firms are often willing to work against an annual fixed fee based on their estimate of the time required to do the work. If their estimates prove inaccurate, the difference is reflected in setting the next year's fee, but not in extra charges for the current year. Large firms, on the other hand, usually have a policy of billing for actual time and charges. As a result, they sometimes will not quote a fixed fee. In terms of eliminating the possibility of a significant budget variance, operating against a fixed fee can be an advantage to the school.

V. Working with the CPA

The agreement between the school and the CPA should be committed to writing each year in a formal "engagement letter," which is a statement by the CPA of the work to be performed by both the auditor and the school and of the cost of the auditor's services. The letter sets forth a general statement of the auditing procedures to be followed and describes the type of opinion that the auditor plans to render on the financial statements. It also describes the work the school must do to prepare for and help with the audit. The letter also usually describes some of the benefits the school should derive from the audit. Finally, the letter clarifies the responsibility the auditor takes for the detection of fraud. Contrary to popular belief, an annual audit is not a guarantee against fraud. It is important that the trustees and the auditor have a common understanding about the role of the audit in fraud detection and prevention.

Under ordinary circumstances, it is a good idea for the finance committee of the board of trustees to meet with the auditor twice a year. One meeting should take place well before the audit begins. At this meeting, the engagement letter is discussed and the audit plan is reviewed. Even if a preplanning meeting is not held, it is very important to hold at least one meeting each year following completion of the audit. At this meeting, the audit report is reviewed and the management letter is discussed.

One way the school can substantially cut its annual audit fee is to have the business office prepare as many of the audit workpapers as possible. The audit can proceed much more quickly if the auditor can concentrate on reviewing and checking workpapers already prepared by school personnel than if he or she must first prepare the schedules and then audit them. The auditor can specify what schedules are needed and how to construct them.

Auditing and accounting considerations are important in selecting an ending date for the school's fiscal year. Although the trustees may change the year-end date if there are strong reasons for doing so, we recommend June 30, for the following reasons.

The audit should be done as soon after the end of the school year as possible. Because of the extra work involved for the business office, the audit should also be scheduled to coincide with a slack period for the school. There is no more convenient time to undergo an audit in a school than July or August.

Since the summer months also tend to be less busy for CPA's, they also have more time to do an unhurried audit during July or August. Furthermore, the CPA is often willing to take on work in this slower summer season at rates below those charged in the peak winter season.

It is convenient to have the end of the fiscal year coincide with a fiscal quarter as defined by federal tax legislation in terms of verifying payroll and tax information in connection with federal tax returns. June 30 ends a federal quarter, whereas July 1 starts a new quarter.

Whatever date is chosen, the fiscal year should end after one academic year ends and before the next one begins.

VI. Changing CPA's

If the trustees feel that the present auditing firm is not meeting the school's needs, they should discuss their concerns openly with the auditor. It is completely appropriate for the trustees to make their expectations known and then to hold the CPA to meeting them. If expectations continue not to be met, it is appropriate to change auditing firms.

The board of trustees must approve a change of auditing firms. If a change is made, the new auditing firm should be selected very early in the

fiscal year so that the new firm will have ample time to plan for its first audit.

The new auditor will get in touch with the prior auditor before accepting the engagement. This is a matter of standard practice among CPA's that does not imply a lack of trust on the part of the new CPA. The new auditor reviews the prior auditor's workpapers to help make a smooth transition in the changeover year.

We do not recommend periodic changing of auditing firms for change's sake. We believe that, as long as the school is satisfied with the service being rendered, the advantages of continuity and familiarity outweigh any potential disadvantages from loss of objectivity.

Chapter 6

BASIC ACCOUNTING SYSTEMS

In writing this manual, we recognize that many independent schools are not of sufficient size to warrant the establishment of sophisticated accounting systems.

We have therefore included this chapter to illustrate some basic accounting systems that will enable even the smallest school to maintain a "system of bookkeeping adequate to record, classify, and summarize all financial transactions in accordance with recommended accounting principles and practices." We want to emphasize that the systems, forms, and procedures illustrated here are offered only as examples of typical approaches. The functions of such systems are more important than the particular physical appearance of the forms used. Any form may be modified to suit the needs of the school or ignored if an adequate alternative system exists.

Almost every step of the accounting process has been "automated" to some degree, ranging from the use of rubber stamps and multiple-copy forms to time-sharing computers. This chapter focuses on manual accounting systems. Chapter 7 discusses automation of the accounting system by means of mechanical or electronic equipment.

I. Journals of Original Entry

Journals of original entry contain the chronological recording of financial transactions that indicate respective debits and credits that are later posted to individual accounts in the general and subsidiary ledgers. Thus, no entries should be posted to the general ledger that have

not first been recorded in one of the journals of original entry. Examples of journals of original entry are the cash receipts journal, the cash disbursements journal, and the general journal, which are discussed below. Correspondingly, all postings to individual general ledger accounts should be referenced to the appropriate journal of original entry so that one may always readily locate and examine the description of the complete transaction from any one element of it.

Journals are often maintained on multicolumnar sheets for purposes of convenient summary. For instance, a columnar spread of frequently used expenditure classifications or accounts in the cash disbursements journal serves to group charges of similar type for later posting in total to the general ledger accounts affected. The cash receipts journal uses the same columnar format to distribute types of receipts so that summary totals may be posted to the ledger accounts at the end of the month.

Many schools maintain a student tuition, or student account, journal, in which they record, student by student, the detail of tuition and fees assessed and revenues received. This detail is summarized and periodically recorded in, or balanced to, the general ledger accounts affected.

A. Cash Receipts Journal

The receipt of cash should be recorded daily in a cash receipts journal. This journal can be used to record in detail each item of cash received or, in those instances when subsidiary listings are maintained, for the detail of tuition payments, investment dividends, gifts, and other receipts to summarize daily receipts by type.

Form 6-1, below, illustrates a typical cash receipts journal. Frequently used accounts may be preprinted on the page. An "other" column

is included for less frequently used accounts. At some regular interval, probably monthly, the cash receipts journal should be posted in summary fashion to the individual general ledger accounts.

A good element of internal control is to deposit the day's cash receipts intact to the appropriate bank accounts so that total receipts according to the bank (deposits) and according to the cash receipts journal are in agreement.

B. Cash Disbursements Journal

A cash disbursements journal is basically a record of cash disbursements that can easily be set up to indicate both the expenditure accounts to be debited and the proper cash account to be credited. Form 6-2 illustrates a cash disbursements journal that provides this capacity.

Checks are posted to the cash (credit) column of the cash disbursements journal as they are paid. As each check is paid, the remainder of the applicable line is filled in with the expenditure accounts to be charged. Frequently used expenditure categories and types may be set up as columnar headings.

It is also desirable to maintain a sequential record of checks written. This is easily accomplished if a three-part snap-out check voucher is used for making payments. Each three-part set is essentially a check and two carbon copies. The first carbon may be filed in numerical sequence, by check number. The second carbon may be attached to the invoice and receiving slips and be filed alphabetically by vendor for reference purposes. The distribution of the charges to expense accounts may also be indicated on the check voucher, as illustrated in Form 6-3.

If individual payroll checks are disbursed from the general checking

account, a separate payroll journal or register should be maintained, containing required payroll information, as illustrated in Form 6-5. Payroll and other expenses are posted to the appropriate columns, and the liabilities arising from employee withholdings are simultaneously recorded. (See section II, below, on the payroll register.)

C. General Journal

The general journal should be used to record all entries or postings to the general ledger that do not originate in other books of original entry. The general journal thus contains journal entries for noncash transactions, such as the recording of tuition revenue in accounts receivable and transfers between funds or fund groups.

The general journal contains journal entries showing the accounts and amounts to be debited, and the accounts and amounts to be credited, together with an explanation of the journal entry. The entries shown in Chapter 3 are set up in this recommended format. Each journal entry should be numbered and dated for reference purposes. Postings to the general ledger should indicate the journal entry number. Frequently, the first digit of the journal entry number indicates the month, with entries then numbered consecutively within that month--January, 1-1, 1-2, 1-3; February, 2-1, 2-2, 2-3; and so on.

If standard or repetitive journal entries are made monthly or at some other interval, it is often convenient to preprint the account names and numbers, filling in only the dates and amounts at the appropriate times. This is called a recurring journal entry.

Form 6-4 illustrates postings to a general journal.

II. Payroll Register and Individual Earnings Record Card

For schools having more than 20 to 30 employees, it is generally preferable to establish a separate payroll checking account and payroll register to segregate that accounting function from the school's other disbursements. The need to provide an accurate accounting to employees and to outside agencies about employees' gross pay, net pay, and various withholdings, as well as the desire to handle this entire operation efficiently and accurately, strongly supports the use of a separate payroll register and related individual employee earnings records.

The payroll register illustrated in Form 6-5 can be used to calculate and record the details for each individual employee. When the payroll is completed, the various columns are totaled and posted in summary fashion to the general ledger or a journal of original entry. (See Chapter 3, journal entry 13, pp. 75-76). A check is drawn on the regular checking account for the amount of the total net pay and is deposited in the payroll bank account. Individual employee checks are then drawn from the payroll account.

Form 6-6 illustrates an individual earnings record in which basic payroll information is recorded and earnings data are accumulated to provide the basis for the various payroll reports required periodically by state and federal agencies. This form should be supported by the proper documentation for changes in wage and salary rates, withholding authorizations, and similar items.

To eliminate some of the repetitious and time-consuming posting of data involved in payroll preparation, several "one-write" or pegboard payroll systems have been developed. Such devices permit preparation of the individual payroll check and the simultaneous posting of a payroll

register and individual earnings records in a relatively simple manner. These systems are quite inexpensive and are available from publishers and business forms printers and suppliers.

Also, commercial bank computers and other service bureaus do payroll processing. If an outside service bureau is to be used, the school should make sure that the bureau is familiar with "school payroll problems."

III. General Ledger

The general ledger is a record of all financial transactions classified and summarized by individual account. It is the final and permanent record of transactions. From it are obtained the data for the preparation of financial statements and operating reports.

The general ledger is normally set up in the same account sequence as the chart of accounts. At the end of some convenient time period, say, monthly, the transactions posted in the journals of original entry are summarized and the total debits and credits for each balance sheet, revenue, and expenditure account are posted to the respective general ledger accounts (see Form 6-7). All postings to the general ledger are referenced, according to the date and source of the entry, so that there will always be a clear trail back to the source of the original entry.

A "trial balance" of the general ledger by fund groupings, which is a listing of the debit or credit balance of each account, should be produced monthly to ensure that total debits equal total credits.

IV. Petty Cash Funds

Every school needs petty cash funds for the prompt and convenient payment of small items or to make change in the school snack bar or store.

A petty cash or change fund may be established by issuing a check

payable to the custodian of the fund for \$25 or some other appropriate amount. The establishment of the fund is accounted for as a debit to a cash account representing the fund and a credit to the regular cash account. The petty cash fund should have this original balance on the books until the amount of the fund is changed.

Whenever cash is disbursed from the fund, a petty cash voucher (Form 6-8) should be prepared, indicating the reason and amount of the disbursement, an approval signature, and the signature of the person receiving the cash. The vouchers are kept in the petty cash box (together with a receipt, if one can be obtained). At all times, the total of the actual cash and vouchers in the box should equal the amount originally authorized in the fund.

When the amount of cash reaches a low level, or at the end of the month, a check is drawn on the regular checking account to replenish the fund equal to the amount of petty cash vouchers. The amount of the replenishment check is distributed to the expenditure categories indicated on the individual vouchers. Vouchers should be marked "canceled" at this point to avoid fraudulent reuse. If the fund is used exclusively for change-making purposes, the fund should be restored to its authorized balance at the end of each day, and any additional monies should be reported as appropriate revenues.

V. Purchase Order/Receiving Form

As the volume of purchases increases, it is often desirable to create some documentation to standardize and control the purchasing cycle. The purchasing cycle involves the following elements.

Request for purchase by a school department or office

Purchase order from the school to the vendor
Record of receipt of goods from the vendor
Authorization to pay the vendor's invoice
Record of payment

A multipurpose form, such as that illustrated in Form 6-9, can be used to document this purchase cycle. Appropriate signatures indicate the people requesting, purchasing, receiving, and authorizing payment.

The form may be prepared in four copies, with the original copy being sent to the vendor. A second copy is sent to the person requesting the purchase to show that the order has been placed. The third and fourth copies are kept in an open order file until the goods are received. The third copy then serves as a receiving copy. When the vendor's invoice arrives, the invoice is matched with the receiving copy, coded for expense account distribution, and presented to the appropriate person for payment authorization. Upon payment, the receiving copy of the purchase order and the invoice are stamped "paid" (to avoid duplicate payment) and filed by purchase order number to provide a record of the history of the purchase. The fourth purchase order copy is filed alphabetically by name of vendor and serves as a permanent record of purchases from that vendor.

Cash Receipts Journal

DR Cash

Date	Description	Bank Deposit	Unrestricted 1-1-10-00	Other		Accounts Receivable Tuition 1-1-20-00	Accounts Receivable Other 1-1-30-00	Other Account	Sources Amount										
				Account	Amount														
9-27	Tuition - Robert Jones	100000	100000			100000													
9-27	Tuition - Steven Smith	100000	100000			100000													
9-27	Annual Alumni Giving	157500	157500																
9-28	Dividends - IBM - Unrestricted Endowment	11000		1-1-10-00	11000				157500										
9-28	Sales - Bookstore	67529	67529						11000										
9-28	Sales - Snack Bar	72819	72819						67529										
9-28	Incidental Expenses - J.F. Smith	5210	5210						72819										
								5210											

Form 6-3

Check Voucher

NO. 3 COPY

NO. 2 COPY

ORIGINAL

YOUR SCHOOL NAME

CHECK NO. _____

DATE _____ 19 ____

PAY _____ DOLLARS \$ _____

TO THE ORDER OF _____

BY _____

AUTHORIZED SIGNATURE _____
AUTHORIZED SIGNATURE _____

DATE	INVOICE NUMBER	DESCRIPTION			AMOUNT	DEDUCTIONS		NET AMOUNT	
						CODE	AMOUNT		
A.									
PAY PERIOD ENDING	HOURS	GROSS PAY	F.I.C.A.	WITH- HOLDING	OTHER DEDUCTIONS			TOTAL DEDUC- TIONS	AMOUNT OF CHECK
B.									

Note: Schools using separate checks for payroll would design the check voucher using the columns designated in row B only.

Form 6-4

General Journal

Date	Account	Account Number	Amount	
			DR	CR
9-15 9-1	Accounts receivable - Students	1-1-31-00	500000.00	
	tuition revenues - To	1-4-11-00		500000.00
	record tuition revenues for the year.			
9-30 9-2	Cash - operating - unrestricted	1-1-11-00	75.00	
	Cash - restricted	2-1-11-00	500.00	
	Gifts - unrestricted - parents	1-6-20-00		75.00
	Gifts - restricted - parents	2-6-20-00		500.00
	To record gifts received			

Form 6-5

Payroll Register

PAYROLL FOR WEEK ENDING _____															DEPT. _____		
															PAGE _____		
LINE NO.	NAME	HOURS *			RATES *		TOTALS			DEDUCTIONS					NET PAY	CHECK NO.	
		REG.	OT	TOTAL	REG.	OVER-TIME	REG.	OVER-TIME	GROSS WAGES	FED. INCOME TAX	STATE INCOME TAX	FICA	GROUP INSURANCE	OTHER			TOTAL
1																	
2																	
3																	
4																	
5																	

*For part-time employees and others paid on an hourly basis.

Form 6-6

Individual Earnings Record

[illegible]

*For part-time employees and others paid on an hourly basis.

Form 6-7

General Ledger

Account No 1-1-10-00

Unrestricted Cash

		1		2		3		4	
Date	Post	Ref	DR	CR	Balance		DR	CR	
7-1	Balance forward		27500.00			27500.00			
7-31	CR 1		2250.00			29750.00			
7-31	CR 1			1200.00		28550.00			
8-31	CR 3		1100.00			29650.00			
8-31	CR 3			2700.00		26950.00			
				</					

Form 6-8

Petty Cash Voucher

NO. 36

AMOUNT \$ 2.50

RECEIVED OF PETTY CASH

10/22

0

FOR Postage - Business Office

CHARGE TO Postage Account No. 1-5-73-65

APPROVED BY

RECEIVED BY

Form 6-9

Purchase Order/Receiving Form

NAME OF SCHOOL ADDRESS PURCHASE ORDER / RECEIVING FORM														
TO ADDRESS _____ CITY _____		MONTH DAY YEAR DATE / / ORDER NO. _____												
SHIP TO ADDRESS _____ CITY _____														
QUANTITY		DESCRIPTION	UNIT PRICE	AMOUNT										
ORDERED	RECEIVED													
SIGNATURE _____ REQUESTED BY _____ RECEIVED BY _____ DATE _____														
SIGNATURE _____ APPROVED _____ SIGNATURE _____ FINANCIAL OFFICER _____														
<table style="width: 100%; border: none;"> <tr> <td colspan="2" style="text-align: center;">EXPENSE DISTRIBUTION</td> </tr> <tr> <td style="width: 50%; text-align: center;">A/C</td> <td style="width: 50%; text-align: center;">AMOUNT</td> </tr> <tr> <td>_____</td> <td>_____</td> </tr> <tr> <td>_____</td> <td>_____</td> </tr> <tr> <td>_____</td> <td>_____</td> </tr> </table>					EXPENSE DISTRIBUTION		A/C	AMOUNT	_____	_____	_____	_____	_____	_____
EXPENSE DISTRIBUTION														
A/C	AMOUNT													
_____	_____													
_____	_____													
_____	_____													

Chapter 7

AUTOMATING THE ACCOUNTING SYSTEM

Automating the accounting system can provide greatly varying benefits, depending on the size and complexity of the school and the particular form of automation that is chosen. Many different levels of automation are possible. To the school that uses a purely manual accounting system, a simple pegboard or "one-write" system represents one form of automation. At the other end of the spectrum is the use of a "mainframe computer" data-processing system to perform all accounting functions and provide up-to-date, sophisticated management information whenever needed. Somewhere between the extremes of a purely manual system and a large computer system is a cost-effective method of helping school administrators cope with their ever-increasing accounting and management burdens.

Basically, automation can be accomplished in one of two ways: (1) an outside service bureau that processes the school's accounting data, based on data supplied by the school, and provides printed reports to the school, and (2) internal (in-house) equipment that provides some level of data handling and automatic processing.

I. Outside Service Bureau

There are two obvious advantages to using a computer service company. First, such a company typically uses rather sophisticated computer equipment that would be too expensive for an individual school. Second, a service bureau relieves the user of any burden of running the equipment. School people need to deal only with familiar accounting data and procedures, while the service bureau processes the data and returns them in

finished form--payroll checks, a disbursement journal, board and tuition statements, and the like. Typically, data are sent to the bureau on input documents or forms prepared by school personnel. The data are then recorded in "machine readable" form for the service bureau's computer, which normally causes a lag in availability of current information because of the turnaround time required by the bureau to receive, enter, and process data before returning the finished output. However, this delay is not usually critical for an independent school.

The service bureau is a good solution if the programs it offers meet the school's requirements and if the school does not fear any loss of control or confidentiality by relying on a third party to provide information on a timely basis. The cost of the service is a one-time set-up charge plus a variable monthly charge based on the volume of data processed. When the monthly volume of data processed is small, as it is for most independent schools, the service bureau may well be a cost-effective alternative.

II. In-House Equipment

The "in-house" approach to automation covers a broad range of options. In-house systems can be broken into seven categories, each of which represents a particular level of automation. There is a definite overlap between the high level of one category and the lower level of the next. Generally speaking, the categories are

- One-write or pegboard system
- Posting or bookkeeping machine
- Mechanical accounting machine
- Electronic accounting machine
- Magnetic record accounting machine

Minicomputer

Mainframe computer

Briefly, these categories or levels can be differentiated as follows.

A. One-Write or Pegboard System

This approach uses a mechanical device that enables the bookkeeper to enter information on multiple forms in a single transcription--thus, "one-write." For example, with the payroll, the bookkeeper can simultaneously prepare the payroll check, the payroll journal, and the updated earnings record card. In the area of cash disbursements, one writing simultaneously prepares the check, the cash disbursements journal, and the updated general ledger sheets.

One-write systems minimize clerical transcription errors and ensure that each transaction is fully recorded in all applicable places in the accounting system. Such systems are very inexpensive and represent a useful first step in automation for the small school.

B. Posting or Bookkeeping Machine

Usually a mechanical desktop device, this machine expedites the manual account-posting process and also updates all accounting records simultaneously, as in a manual one-write system. It provides machine-printed records on individual ledger cards with back-up journals. This type of machine provides only numeric data entry. Alphabetic data cannot be entered. Its advantages are in legibility of printed records and speed and accuracy of mechanical updating of balances entered by the operator when posting transactions. Also, a limited number of account totals is usually available.

Such machines are usually purchased outright or on an installment basis. It is not difficult to train bookkeeping personnel to operate the machine.

C. Mechanical Accounting Machine

This machine is almost the same as a bookkeeping machine, except that it has an alphabetic as well as a numeric keyboard, which means that it performs more functions than merely account posting. In addition to posting and updating the accounting records, the machine can also prepare vouchers, checks, descriptive journals, and statements.

D. Electronic Accounting Machine

This machine is basically a modernized mechanical accounting machine, in that mathematical operations are performed by electronic circuitry rather than by mechanical registers. More advanced versions also execute preprogrammed instructions to manipulate data and store limited constant data electronically, rather than through the use of mechanical program bars. The advantages here are faster and quieter operation and the greater reliability of an electronic device over a mechanical one. This machine also tends to offer more in the way of arithmetic logic, such as the ability to do operations requiring multiplication and division.

As with bookkeeping machines and mechanical accounting machines, the electronic accounting machine is typically purchased outright or on the installment plan. Training people to operate it is not a major problem.

E. Magnetic Record Accounting Machine

Up to this point, we have discussed systems that deal only with data entered by the operator, perform some mathematical function with

those data, and print the results on ledgers and/or journals. The magnetic record accounting system, however, provides a method of storing the repetitive data connected with each account, so that the operator only has to enter variable, or new transaction, information. Both old and new data are automatically stored on a magnetic stripe attached to each account ledger card, or on a separate magnetic card, one for each account ledger. The stored data may be either numeric or alphanumeric, depending on the sophistication of the unit.

As the capacities of various magnetic record accounting machines vary greatly, so do purchase prices. Two factors that affect both performance characteristics and price are the size of the central processor (memory), and the ability to use additional or peripheral devices. The memory size and type determine data-processing speed and program sophistication available to the user. Peripheral devices, such as magnetic tape cassettes, allow capture and storage of transactions for later account updating and provide a means for the external storage of programs too large to be stored simultaneously in the memory.

F. Minicomputer

The minicomputer is considered by many to be the most practical of the in-house systems available today to independent schools. A minicomputer has essentially the same capacities that were associated only with large-scale computers just a few years ago. However, the minicomputer is frequently in the same cost range as much of the equipment we have already discussed. Although the minicomputer provides many of the capacities of large computers, it tends to be "operator-oriented," that is, it is designed to allow non-computer-oriented people to operate it. The key

advantages of a minicomputer are related to its ability to store reasonably large amounts of data in a directly accessible mode and to perform complicated and repetitive operations quickly and automatically. For instance, a typical minicomputer may employ a rotating disk storage device to store not only the complete chart of accounts with all balances but also all general ledger control accounts and student accounts receivable. This means that a hard-copy ledger would not be needed at all for storing or handling actual account data. A hard-copy record could be maintained, if desired, for physical observation, but this is purely optional. The minicomputer is normally available in what is popularly called a "turnkey system," whereby the supplier provides the equipment (hardware), the application programs (software), and complete training of operators, as well as ongoing equipment maintenance and support.

G. Mainframe Computer

This final category is probably what most people think of when the term "computer" is used. Mainframe computers are employed in operations that require large volumes of data and/or very complex calculations. They generally involve a staff of specialized people to operate them successfully. They are very expensive and are not practical for the vast majority of independent schools.

III. Which Functions To Automate

When investigating automation for the school, the key issue is to select a system that fits the school's particular needs. The system chosen must, of course, provide a solution for large problems or bottleneck operations in the present accounting process. The school may want to stop there, initially, and automate only those functions that are most troublesome to

handle manually. However, the more applications that can reasonably be handled by the system the more cost-effective the system will be. Thus, it pays to review not only immediate requirements but also future application needs, both functional and informational, in deciding how far to go in automating the accounting system.

The following applications lend themselves readily to automation.

- Student billing - tuition and board
- miscellaneous

- Accounts receivable records

- Chart of accounts expense distribution

- General ledger

- Payroll

- Cash disbursements

- Preparation of periodic financial statements

It should be noted that it is possible to automate the generation of financial statements only if the daily transactional data needed to produce the reports are being captured automatically as well.

It is a general rule that the more automatic data-handling capacities an in-house system has, the more expensive it will be. However, over the past few years, the computer industry has come up with relatively low-cost and rather sophisticated accounting systems.

The first step in considering automation is carefully to define the school's functional and informational needs. Once these are well defined, the cost of any system is then based on exactly how much automation the school is willing to buy. That is, any vendor must show the school the methods available to meet its needs and what the resulting one-time and

recurring costs will be. The school's objective is to get the most performance available for each dollar spent. It may be, in a given situation, that spending slightly more money than originally anticipated will provide additional long-range benefits. On the other hand, the school should be careful not to try to automate every detail of an existing system, lest it end up spending a dollar to get 10 cents' worth of information.

The major factors to consider in every application that appears to be a candidate for automation are

- Transactional volume
- Size of files required to be maintained
- Mix of repetitive applications versus one-of-a-kind projects
- Frequency of processing required
- Cycle of reports (turnaround time)
- Data manipulation required (sorting, re-sequencing, file merging, etc.)
- The one-time cost for installation and start-up
- The repetitive, ongoing cost for automated versus manual data processing

IV. A Typical Automated Accounting System

A typical in-house minicomputer system that addresses the needs of many independent schools is able to store individual account information and individual employee information either internally or on magnetic memory cards. It provides alphanumeric input and output through a typewriter-like device and allows for hard-copy, visible records through the use of ledger cards and journals. Because such a system is available from more than one computer manufacturer, we suggest that the school consider more

than one source before making a final decision.

A typical automated accounting process would involve the following features.

A. Billing and Accounts Receivable

Accounts receivable is separated into tuition and board and incidental expenditure accounts. Tuition and board accounts, usually billed on a regular basis, do not present major accounting problems. Incidental expenditures are posted regularly to student accounts. The system posts the expenditures on a weekly or monthly basis so as to keep an accurate and up-to-date report of account balances. Each student has at least one ledger card and statement for tuition and for expenses.

B. Student Statements

Student statements should be produced concurrently with the accounts receivable ledgers. They might fit over the student's ledger card so that all of the monthly transactions will be recorded. At the end of the month, each statement is complete and ready for mailing.

C. Cash Receipts

The cash receipts program reflects changes in accounts receivable through cash received from parents, with each student's ledger card showing the appropriate changes in balance due. After all monies have been recorded, a cash receipts journal is produced as an automatic by-product. This record, combined with the billing record, gives a complete picture of accounts receivable.

D. Payroll

The payroll can also be done automatically. All pertinent infor-

mation for each employee, such as name and address, social security number, dependents, deductions, year-to-date totals, and all necessary tax information, are stored internally or on employee memory cards. The operator needs to be concerned only with the number of hours worked, miscellaneous earnings, and miscellaneous deductions. Everything else is totally automatic.

The system calculates all taxes, new year-to-date totals, and writes the check with asterisk protection. It should also provide for automatic FICA cut-off.

The payroll journal and the employee pay stub are prepared automatically as a by-product of the preparation of updated employee earnings cards and payroll checks. The system should also automatically complete the quarterly 941 reports and the year-end W-2 reports.

E. Cash Disbursements

The cash disbursements program should provide for a cash disbursements journal, remittance advice, check-writing, and posting to general ledger accounts. The first step is to take all the invoices from a vendor and post the amount affecting the general ledger to the appropriate general ledger card. This enables the operator to post as many different accounts as needed for any one invoice or multiple invoices from a vendor. After all invoices have been posted to the general ledger and the remittance advice has been recorded, the system automatically writes the check with asterisk protection. Two operations are thereby combined into one, thus saving time and ensuring proper control and accuracy. The disbursements journal provides an excellent record of all expenditures, listed by check number.

After the run of check-writing and posting is completed, the cash

disbursements journal should automatically total out by the appropriate categories. Data for each general ledger account can be stored internally, or each account can have its own magnetic memory card. These records hold the balance for the account and the current amount posted for the monthly report. By use of the cards, the operator need not manually enter a proof and balance each time a posting is accomplished. If the general ledger account files are stored internally, the operator simply enters the account number for each posting to recall the general ledger file and then posts it to the ledger card.

F. General Ledger Report and Financial Statements

These reports can be generated at any time from the data stored internally or on the magnetic memory cards. The reports should provide for arrangement of accounts in any number of groups and allow for multiple levels of totals. If desired, the reports can then be run several times, varying the groupings, account sequences, and/or totals taken. Each account printed should display monthly expenditures, year-to-date expenditures, budget allocation, and the variance between the budget and the year-to-date figure. It is also possible to have the system produce condensed statements of financial position and operating results.

G. Modular System

Whichever approach to automation is selected, a "modular" or "building-block" design allows for the addition of peripheral equipment in the future to increase processing capacity. In this way, the school can avoid buying unneeded capacity. When processing volumes or additional application programs require it, extra capacity can be added.

V. Conclusion

The day is rapidly passing when manual record-keeping is cost-effective for even the smallest independent school.

Some form of automation, even if only a pegboard system, should probably be used in every independent school.

The decision about which form of automation is best for any given school at any given time is a difficult one that should be made by the trustees upon the recommendation of the business manager, who in turn should consult the school's independent accountant and one or more vendors of automated systems.

Chapter 8

BUDGETING CONCEPTS AND PROCEDURES

Because the annual operating budget of the school reflects the intersection of educational programs and school finances, we feel that budgeting deserves separate, specific consideration in this manual. In this chapter, we give a summary of the basic issues, concepts, and procedures related to preparing and administering the operating budget.

There is no more important management tool in an independent school than the budget for operating expenses and the related reporting of budgeted versus actual expenses. Properly used, this tool gives the administrator leverage that will yield educational results far greater than the time and effort invested. To neglect this tool, or to treat it solely as an obligatory, technical exercise, may cut the head of the school and the faculty out of educational planning and may delay or entirely block any real educational growth. If funds are inadequate, a thoughtful budget is essential so that what funds are available can be used with the greatest educational effectiveness. If funds are plentiful, the school must still develop budgets in a spirit of creative planning if educational excellence is to be sustained over the years.

Stated most simply, a budget is an itemized estimate of income and expense for a given period in the future. Obviously, such an estimate can cover a variety of periods and a variety of incomes and expenses. Here, our emphasis is on the annual operating budget, an emphasis that excludes consideration of other kinds of budgets, such as the long-range planning budget, the capital budget, or the cash budget. The cash budget is considered in Chapter 9. Long-range planning budgets are considered

in Chapter 10. The capital budget normally covers the same one-year period as the operating budget but has to do with nonoperating funds.

In drafting this chapter, we have drawn heavily on the monograph Introduction to Financial Management, by Dexter K. Strong, published in 1971 by NAIS. We refer the interested reader to that publication for a more extensive consideration of that topic.

I. Preparing the Operating Budget - Timing

The "final" budget, the one against which actual results are measured, should be as accurate as possible, a fact that tends to postpone to the latest possible date the setting of a final budget figure. When a major item like tuition income is involved, the school cannot set a reasonably accurate figure until enrollment is complete. For some schools, this may mean April or May; for others, September. For all schools, however, the most accurate figure is one based on opening-day enrollment, since the presence of students confirms the commitments made earlier by parents and thus provides a final budget figure that cannot be challenged. For this reason, many schools approve the final version of their budget at the first meeting of the board of trustees after school opens in September.

Of course, no school waits until the year has begun to start preparing the budget. Starting the process earlier is required because the school must decide no later than midwinter about two of the largest items in the budget: tuition fees and faculty salaries. Neither decision can wait until September. Many heads begin their negotiations with teachers no later than January and hope to have faculty contracts settled by the spring holiday. At that time, the enrollment and re-enrollment of students are at the decisive stage, making it necessary to announce tuition

fees for the coming year. Moreover, these two items are closely linked by logic and necessity. Thus, by about February 1 at the latest, the school must determine two vital budget items, the one probably the largest item of income, the other probably the largest item of expense. With a little work, the school can, at the same time, make a reasonable estimate of the cost of many other items, from wages and food to postage and telephone. Therefore, many schools adopt a "preliminary" budget at a midwinter meeting of the trustees.

If the school's management is to be ready by midwinter to make major decisions on tuition fees and faculty salaries, budget planning must begin no later than the fall term. Moreover, since a budget reflects the financial implications of educational policy decisions, it is necessary to begin the budgeting process early enough to capture the annual reconsideration of educational policies and programs that almost always starts as soon as the new school year begins. Educational planning for 1978-79 begins as soon as teachers and administrators begin the 1977-78 school year. The budget-planning process for 1978-79 must therefore begin in the fall of 1977.

As long as it is clear that the budget must be tentative until much later in the year, the advantages of starting early far outweigh the corresponding loss in "accuracy."

Following is a chronological outline of recommended guidelines for preparing the annual budget. It need not be followed exactly, so long as all the key steps are covered in sequence.

Early September. The head of the school asks each department head and other key administrators to propose preliminary budgets for their areas of responsibility for the coming year. These preliminary budgets

are due in the head's office by mid-October. Specific dollar amounts are requested for all nonsalary items. For personnel, only a proposed staffing or "head count" level is needed.

Mid-September to Mid-October. Department heads and other key administrators discuss next year's expenditure requests with professional staff members in their departments and encourage teachers to be creative and forward-thinking in proposing expenditures that will strengthen their areas within the school. Even though such "wish lists" probably cannot be fully funded each year, this process of determining maximum expenditure levels in the "best of all worlds" is a useful planning exercise. If professional staff members realize that such proposed expenditure lists represent goals to be worked toward over several years, rather than firm one-year requests, the process should continue to be a meaningful one each year.

In order to maintain a clear perspective on which expenditures are necessary in the short run, which are important but not critical, and which are most easily postponed, it is desirable to ask people who submit budget requests to rank items in order of priority.

Schools that give department heads a target dollar figure when asking for preliminary budgets have the advantage of making sure that the budgets that are submitted will realistically reflect what can be spent. The corresponding disadvantage is one of possibly constraining the professional staff unduly in its budget planning. It is generally true among independent schools that income is found to cover legitimate, necessary expenditures. To the extent that this is true, it is important that a certain amount of each year's educational planning take place unfettered by specific concern over how many dollars will be available next year.

In many respects, this issue of beginning budget planning with or without specific dollar limits in mind is one of budgeting philosophy. Thus, each school must think carefully about which path it wishes to follow.

Mid-October to Mid-November. Once proposed departmental budgets are submitted, the head and the business manager must pull all the pieces together to produce an overall preliminary budget. The business manager provides whatever financial expertise is needed to help organize and tie together the bits and pieces in whatever way reflects the head's plans and desires for the coming year. The ultimate responsibility for the budget rests with the head.

It is important for the preliminary budget to be balanced so that projected income equals projected expenditure. If a deficit is projected, there must be some workable plan for finding funds to cover it. If a surplus is projected, there should be a plan for the most useful deployment of excess resources. Once the head and business manager have produced a preliminary budget that makes sense to them, it should be carefully reviewed with the appropriate committee of the board of trustees.

Once this committee approves the preliminary budget, it is a good idea to have an approving vote by the entire board at a midwinter meeting (November, December, or January). It is important that this vote come early enough in the year for changes to be made, if necessary, in such key areas as proposed tuition levels, staffing levels, salary budgets, and/or proposed financial aid allowances. Such decisions should not be locked in for the coming year without trustee approval. It is also important that the preliminary budget be approved by the appropriate committee before the board as a whole is asked to vote on it. This

should ensure, in most cases, that trustee approval is as routine as it should be when careful and prudent budget planning has preceded the request for an approving vote.

Mid-December to Mid-February. During this time, the head takes responsibility for reporting the decisions made by the board as reflected in the approved preliminary budget to department heads and professional staff members. It is critically important that teachers and administrators understand why cuts that have been made were necessary and that they accept the budget as realistic and fair, for they will have to live with it next year. Living with the budget can be very painful for all involved if they cannot accept it as a "consensus-oriented," "best possible" budget.

During this period, new tuition levels are announced to the public, faculty contracts are let, new salary levels are fixed, and financial aid guidelines for use by the admissions office are specified.

May or June. Final changes in the budget are made, based on additional information now available about enrollment levels, inflation rates, and educational program decisions. Any and all changes must be explained to the departments involved, if they are to accept the changes as being legitimate. It is also important for the finance committee of the board of trustees to approve the changes so that it can unanimously endorse the final budget to the entire board.

The board of trustees then makes the final decision on the budget, usually at its June meeting. Many boards like to take action at this time so that an official budget will be on record before the new fiscal year begins in midsummer. Or, if the board waits to ascertain actual enrollment figures, final approval may be given at the September meeting.

II. Past Data versus Zero-Based Budgeting

Several considerations are involved in projecting next year's income and expense: the budget for this year, the estimated result for this year, the actual results for last year, the operating plans for next year, and the forecast of two key variables--enrollment levels and inflation rates. The issue here is whether to use past data as a base for budgeting or to start from scratch.

A natural tendency is to take current spending levels as given and to concentrate only on proposed changes, which usually results in devoting 85 to 90 per cent of the time and effort to 10 to 15 per cent of the dollars. A conceptually more appealing approach is to consider the justification for each dollar of expenditure each year. This process is called zero-based budgeting because it takes nothing as given. The base for a new budget is zero. Every dollar of expense must be defended anew each year. Zero-based budgeting is becoming more and more popular as a budgeting concept in both commercial and nonprofit organizations because it results in devoting the bulk of time and attention each year to the bulk of the dollars.

In practice, of course, it is not feasible to renounce all past commitments each year and start afresh. Past data are always of major importance to a new budget. The zero-based budgeting concept is sound, however, and should be kept firmly in mind each year, lest past decisions be continually reaffirmed without full attention to their present applicability. Nevertheless, it should be kept in mind that past data may well be the most useful source of information on items that recur and are regular from year to year, at least for the time being.

For example, if the school has borrowed money, it will have to pay

a predetermined amount of interest on the loan. Short of finding some way to pay off the debt ahead of schedule, the school has no choice about this expense. Almost as immutable are other items that have been programmed for a period of two or three years, such as an agreed-upon three-year schedule of premiums with a fire insurance company. Unless the situation changes markedly, this predetermined schedule fixes next year's premiums.

Other items, such as postage used by the head's office, are almost as easy to predict. Recent experience, current plans, and a check on postal rates make it easy to set a reasonable budget figure for this item.

III. Budgeting for Faculty Salaries

Faculty salaries, a subject in themselves, deserve special reference when considering budgets. Financially, they constitute the largest single expense item in the budget. In human terms, they represent the heart of the school. Obviously, the quality of a school depends on its ability to attract and hold a good faculty, an ability that depends, at least in part, on faculty salaries. Here, our purpose is more limited. We consider only three questions, all of them relating specifically to the budget-making process: (1) What are some administrative approaches to handling faculty salaries? (2) What part, if any, does the faculty itself play in the discussions? (3) At what level and in what way do the trustees deal with the matter?

Practice differs widely on the first point. In some schools, the head negotiates privately with each teacher each year. This system allows maximum emphasis on the rewarding of merit, but it has the disadvantage of tempting the head to neglect the nondemanding teacher in favor of the

hardened negotiator. At the other end of the spectrum is the system used in most public schools and some independent schools--the published salary scale, with pay based on level of education and length of experience. Properly administered, this system guarantees objectivity but makes it difficult to reward the kind of merit that reveals itself in superb teaching, regardless of the amount of graduate work. Between these two extremes are all kinds of combinations, such as ranges of salaries for differing age groups, and arrangements that allow teachers of differing degrees of merit to rise along one of, say, three different tracks.

The part that faculty members play, officially, in the annual discussion depends on which of these systems the school uses. The head can be sure of one thing: the matter is under discussion. The discussion may be general and public, or it may be restricted to private talk. Whatever the nature of the discussion, the head should know the actual financial needs of faculty members as well as what they think their financial needs are. The two usually are not far apart.

Long before discussing any teacher's salary with that teacher directly, the head, using the system in effect and all the information that he or she can gather, should have worked out a faculty salary proposal and calculated its total cost. These factors should be discussed with the chairmen of the appropriate trustee committees, and probably with the president of the board. If the lowest salary, the highest salary, and the overall salary budget seem reasonable and feasible, the president and the appropriate committee chairmen, with the active help of the head, steer the proposal through the education and finance committees and to the entire board.

The above summary answers in part the question of how trustees deal with the annual matter of faculty salaries. They deal with it, officially, at the committee level and at the board level. However, it is important to note that they are dealing with policy and with financial totals, not with individual teachers. It would be completely out of order for a trustee to communicate with an individual teacher about that teacher's salary. If a teacher complains about his or her salary to a trustee, the trustee should refer the teacher to the head and notify the head about the complaint.

One important matter is sometimes lost in the shuffle: the salary to be budgeted for the head of the school. The president of the board should confer with the head regularly once a year to review the state of the school and the strengths and weaknesses of its administration. Once this review has been made, it is the president's duty, after conferring with at least the chairmen of the education and finance committees, to decide on the head's salary for the coming year and to see that the figure becomes part of budget planning. This procedure does not necessarily rule out some bargaining and negotiation, but it at least saves the head the embarrassment of having to be the first one to propose a financial evaluation of his or her own work. Similarly, the president and head should remember to take the initiative in dealing with the salary of the business manager and other senior administrators who report directly to the head.

IV. Budgetary Control - Implementing the Plan

Once the board has acted, the function of the budget changes. Until now, it has been a financial plan, subject to revision as the school

gathers its facts and makes its decision. Now the budget becomes a firm and detailed control mechanism. The board has authorized the administration to collect and spend specified amounts of money in specified ways. The head carries full responsibility but promptly delegates parts of that responsibility to the business office, the kitchen staff, the alumni/ae office, the librarian, and the heads of academic and other departments. The trustees have, in effect, authorized each of these subunits to act within specified limits without further board action.

Although many school people view the budget as solely a restrictive device, it is important to emphasize its positive aspects as well. As we have already seen, making a budget involves a shared, creative planning process. Even after its adoption, the budget clears the way for the administration and faculty to do their best educational work free from daily worry about the level of financial support. A good faculty and staff, under good leadership, will be eager to get on with the job.

V. Controlling Expenses - Management Techniques

Once completed, the budget does set limits, and the head and the business manager must see that these limits are not exceeded. In some areas, such as faculty salaries, the system runs itself. The business office makes monthly payments on the basis of previous agreements. Except in rare emergencies, the actual figure corresponds almost exactly at year's end with the budget figure. Moreover, a competent department chairman who knows how to keep records, how to plan for the whole year, and how to work with the members of the department needs little help from either the business manager or the head. The head should, of course, be perfectly clear in notifying each department chairman about the nature of his or

her budget responsibility and about the amount available for spending.

In other areas, the head has the help of two standard procedures:

(1) concentration of purchasing authority in the hands of one officer, normally the business manager, and (2) the monthly financial report.

The desirability of the first procedure should be obvious, but some schools do not follow it. Centralized purchasing is no assurance in itself of efficient budget control, but it is a very important first step. The business manager cannot accept purchase orders from everyone in the school. Each purchase order must first have the approval of the department chairman involved or the person to whom the head has delegated budget responsibility for a particular expense category--the librarian or the athletic director, for example. To expedite the process, the business manager may also delegate some purchasing authority to such people as the director of food services, the bookstore manager, the purchasing agent, department heads, or the maintenance supervisor. Even when this is done, the business manager should review purchase orders as a control check.

The second important control procedure is the monthly financial report. The format we recommend below shows, in adjoining columns, the budget amount for the year, the actual amount spent for the year to date, and the latest estimate of actual expenditures for the year as a whole, based on experience to date. Some schools prefer a format that has columns showing actual for the month, actual for the year to date, budget for the month, and budget for the year to date. When this format is used, the variances to be dealt with are budget versus actual for the month and the year to date. Of course, as the year progresses, the year-to-date figures are more important than the current month's figures taken alone. This approach is only useful if it is possible to develop budget figures meaning-

fully on a month-by-month basis. Dividing the annual budget by 12 to get a monthly budget cannot be relied upon to produce realistic month-by-month budgets, except for salary items.

Because of the difficulty of breaking an annual budget allowance down into month-by-month increments, we recommend that schools consider using the monthly reporting format shown first, below. There, the key variance for each expense item each month is the difference between the budget for the year and the latest estimate of actual for the year, based on the available information that accumulates month by month. Under this approach, month-to-month fluctuations in expenses are only important insofar as they indicate a change in estimated expenses for the year as a whole.

Here are the two formats for the monthly financial report.

Format 1

<u>Budget items</u>	(1) <u>Budget for</u> <u>the year</u>	(2) <u>Actual expense for</u> <u>the year to date</u>	(3) <u>Latest estimate</u> <u>of actual for</u> <u>the year as a</u> <u>whole</u>	(3) - (1) <u>Variance</u> <u>of</u> <u>concern</u>
Revenues				
.				
.				
.				
Expenses				
.				
.				
.				

Format 2

<u>Budget items</u>	<u>This month</u>			<u>Year to date</u>		
	<u>Budget</u>	<u>Actual</u>	<u>Variance</u>	<u>Budget</u>	<u>Actual</u>	<u>Variance</u>
Revenues						
.						
.						
.						
Expenses						
.						
.						
.						

Some schools also add the actual figures from last year to the monthly report. To the extent that this year is expected to be like last year, last year's figures are incorporated in this year's budget. In this case, reporting last year's figures is redundant. To the extent that this year is expected to be unlike last year, reporting last year's figures can be misleading. For these reasons, we do not recommend including last year's figures in the monthly financial report.

Many different monthly reporting formats are used among independent schools, and many schools like the format they are using. The key point is to follow up on variances as they develop in monthly reports, rather than waiting until it is too late to take corrective action. So long as this is done, the particular format used is not of crucial importance. The report should be in the hands of the business manager, the head, and the chairman of the finance committee no later than 10 working days after the end of each month in order to allow for corrective action before matters get out of hand. Usually, a conference between the business manager and the chairmen of departments that are exceeding the budget

straightens everything out, but the head's intervention may be desirable if the variances do not seem correctable.

VI. Interim Budget Revision

Budget figures sometimes run over for reasons that cannot be foreseen or prevented. For example, a senior teacher falls ill, and the school must pay both him and his substitute for five months. Or, though the school knows from experience that it will lose 1 per cent of its students during the year and has taken this average into account in the budget, the time comes when, because of some fluke, the figure jumps to 4 per cent. Or a few expenses decrease and some income items exceed expectations. Whether or not these changes balance out, there are two schools of thought about what to do with the budget. Should the trustees revise it three or four times a year, in line with most recent experience? Some boards say yes and act accordingly. Other boards expect to be informed about changes from time to time and to act on important variations, but they let the budget as officially adopted remain unrevised for the operating year. Such a procedure is perfectly acceptable and meets the needs of most schools.

Whether or not the budget is revised during the year, it is important for the budget and the monthly financial report to be arranged in the same format so that ready comparison is possible. The audited annual report should also be arranged in the same format so that budget and actual can be readily compared for the year as a whole. This point seems obvious, but not many schools follow this procedure. The benefits of ready comparison among the budget documents, the monthly financial statements, and the annual financial report cannot be underestimated.

VII. Budgeting in Perspective

A budget, a plan carefully drawn to allow for the efficient educational operation of the school, should not assume other roles. Unfortunately, there are times when it almost takes on a life of its own. One hears, for example, that "the budget won't allow us to do that," as if the budget were a miserly control officer lurking in the background of school life. "We failed to plan for that this year" would express its function better, and these words would remind everyone who participated in the planning that the job must be done better next time. The same is true of budget control. If the entire faculty and administration have had a hand in making the budget, then everyone will know it for what it is and will help to keep it in proper perspective, because everyone will have a stake in making it work.

It is important to remember, however, that it is not the accuracy of the budget or even the participatory processes by which it is developed that are of primary significance. Budgeting and accounting are not ends in themselves. They are only efficient means to an end, and that end is good education.

Chapter 9

CASH MANAGEMENT

I. The Cash Budget

The primary tool in effective cash management is a comprehensive, up-to-date cash budget. A cash budget is different from an operating budget. The operating budget is a 12-month projection of the revenues the school will earn and the expenses it will incur on a month-to-month basis. Progress in meeting the expense budget is monitored as part of the cost control process, but it is the difference between revenues and expenses for the year that is important, not month-to-month differences.

The cash budget is a 12-month projection of all cash receipts and cash disbursements for the school. It is important to keep in mind that cash receipts are not the same thing as revenues earned and that cash disbursements are not the same thing as expenses incurred. For example, some cash receipts this year do not represent earned revenue this year (collection of prior years' tuition). Also, some of this year's revenue will not be collected in cash (tuition waived as financial aid). Also, some cash disbursements do not represent operating expenses (payments on mortgage principal). Finally, some operating expenses do not represent a cash disbursement (financial aid). The cash budget is thus very different, conceptually, from the operating budget, although both are important management tools.

Since the school must maintain adequate cash balances at all times to pay bills as they fall due, it is important to monitor cash receipts and disbursements on a month-to-month basis. Thus, for the cash budget,

month-to-month variations in cash inflows and outflows are equally as important as the overall inflows and outflows for the year. In fact, day-to-day fluctuations in the cash balance are important. As is discussed later in this chapter, most schools maintain a record of their daily as well as their monthly cash balance.

Preparing a monthly cash budget is quite simple. First, total anticipated cash receipts for the year are projected by month. Then, total anticipated cash disbursements for the year are projected by month. Projected month-to-month fluctuations in the cash balance are then calculated, using a summary schedule such as the one shown in Exhibit 9-1. The next step is to consider how projected receipts might be accelerated or projected disbursements be postponed to avoid "red" balances in some months, to reduce the size of "red" balances wherever possible, or to increase the amount of excess cash, which can be invested temporarily for a few months. ("Red" or negative cash balances in the projected cash budget indicate a need for short-term borrowing to finance the temporary deficit.) While the timing of many receipt and disbursement items is not discretionary, other items do allow some flexibility as far as timing is concerned. Those items can be "managed" to produce a more advantageous overall "cash flow" picture. Preparation of a monthly cash budget is illustrated in the hypothetical example at the end of this chapter.

II. Cash Management

An effective cash management program for any organization has three primary goals: (1) to get cash receipts in as soon as possible, (2) to postpone cash disbursements as long as possible, and (3) to invest "excess" cash, while it is on hand, to earn a return. We will consider each of these areas separately.

Exhibit 9-1

Monthly Cash Budget Schedule

	<u>Jul</u>	<u>Aug</u>	<u>Sep</u>	<u>Oct</u>	<u>Nov</u>	<u>Dec</u>	<u>Jan</u>	<u>Feb</u>	<u>Mar</u>	<u>Apr</u>	<u>May</u>	<u>Jun</u>	<u>Totals</u>
1. <u>Cash receipts</u>													
.													
.													
.													
2. <u>Cash disbursements</u>													
.													
.													
.													
3. <u>Net change this month</u>													
4. <u>Beginning balance</u>													
5. <u>Ending balance</u>													

Item 1 - item 2 = item 3.

Item 3 + item 4 = item 5.

Item 5 for one month becomes item 4 for the next month.

A. Cash Collection Policies and Procedures

The primary source of cash for the independent school is tuition income. It is very important for the board of trustees to establish a policy that ensures that tuition will be collected as promptly as possible. Such a policy should cover the following issues.

How large an enrollment deposit is to be charged?

When will tuition bills be mailed?

When is tuition "due"?

When "must" tuition be paid?

Who is responsible for following up on unpaid amounts between the "due" date and the "must be paid by" date?

What sanctions will be applied if payment is not received?

We strongly recommend that the school have a formal enrollment agreement, or contract, with parents that clearly spells out the tuition policy in terms that they can understand and accept.

The school's enrollment contract should accompany the letter of acceptance that goes to new students as well as the confirmation notice that is sent to returning students in the spring. Multiple copies may be prepared for the people who need them--the parent, the director of admissions, and the business manager. In addition to reflecting the policies outlined above, the contract should include some or all of the following details.

Name and address of student offered admission

Space for parent or guardian to sign (accept) the enrollment contract

Consideration and details of payment (deposits, dates, amounts due)

Policy on withdrawal for various reasons and on whether or not the school offers tuition refund insurance; date and method of canceling contract without penalty

Reference to rules contained in the school's catalogue

Statement (optional) that the school is nondiscriminatory (see IRS Revenue Procedure 75-50)

Space for the school to acknowledge its acceptance

It is essential that the school work closely with its legal counsel to develop an enrollment agreement that is appropriate to its own circumstances.

As for enrollment (and re-enrollment) deposits, the recent trend in most schools has been to move from a very small deposit (\$25, for example) to a much larger sum (\$200, for example). This larger deposit, which brings cash in to the school to cover expenses during the summer months, is usually applied to the second semester's tuition, which is another "cash flow" advantage for the school.

Recommended practice for mailing tuition bills is to send all of them in July or early August. Mailing bills before the school year actually begins is not unfair to parents, since tuition is not necessarily due when the bill is sent. Some parents will go ahead and pay early when the bill is mailed early, which accelerates the fall semester cash inflow--always advantageous to the school. However, if bills are mailed too far ahead of the opening of the school year, there is the danger that a second notice might have to be sent in the fall to remind parents that tuition is due.

General practice regarding tuition due dates seems to be to require 50 to 60 per cent in September and 40 to 50 per cent in January and

February. We do not recommend breaking the payment schedule into more than two parts because of the negative impact on cash flow. Also, when payment is broken into more than four parts--including the advance deposit--the payment arrangements may fall under federal "truth in lending" legislation covering installment payments.

A few schools require that all tuition be paid in September, which naturally gives the school much more advantageous "cash flow." Parents in those schools have not raised major objections to this method, and it has had no noticeable negative impact on applications. Also, having all tuition paid in September avoids disputes over contractual obligations in cases of midyear withdrawals or dismissals.

As for collection procedures in cases where tuition is not paid when it is due, we strongly recommend that the head of the school not get involved in the collection process so as to avoid any possible strain on his or her relations with parents. This function is best left to the business officer or the treasurer of the board of trustees. Although the school's business officer assumes primary responsibility for correspondence and other follow-up activities, the trustees must assume final responsibility for this troublesome but very important area. If the school does not wish to handle such problems itself, it can call on the services of a collection agency or an attorney who specializes in collecting unpaid bills. The school's banker should be able to recommend a reputable firm or attorney.

Many schools charge interest on tuition that remains unpaid beyond the scheduled due date. Typical monthly rates of interest are 1 to 1-1/2 per cent (annual rates of 12 to 18 per cent). Allowing parents to extend payment of tuition in exchange for an interest "carrying" charge has both

advantages and disadvantages. One advantage is more flexibility for parents in scheduling their tuition payments. Another advantage is additional income for the school. An annual return of 12 to 18 per cent on uncollected tuition is usually more profitable to the school than collecting tuition in full and then investing it temporarily. The principal disadvantage of deferred payment plans is the possibility of collection problems when payment is delayed too long. We strongly discourage allowing tuition payments to be extended beyond March or April.

If a school adopts the policy of charging interest on unpaid tuition, it becomes subject to the provisions of federal "truth in lending" legislation, which has three basic requirements.

All persons must be treated alike, with no exceptions to the stated policy.

All parents must receive formal advance notification of the policy, which can be included in the enrollment agreement.

The annual interest charge must be clearly disclosed. This can be included in the enrollment agreement; it should be covered in each tuition bill.

The provisions of the "truth in lending" legislation are quite complex in some instances. The provisions and administrative interpretations are explained in the publication Truth in Lending: Regulation Z, prepared and distributed by the Board of Governors of the Federal Reserve System. Some states also have statutes covering lending practices. It is important for the school's legal counsel to verify that the school's policies and practices in this area are in accordance with the provisions of all relevant legislation.

It should be noted that granting tuition discounts for early payment

constitutes "negative" interest and thus is covered by Regulation Z of the "truth in lending" law.

Some schools have followed the practice of withholding transcripts when tuition remains unpaid beyond a reasonable period. The courts in many states have rejected this practice as being illegal. If a student completes the school year and receives grades, the school may not withhold the reporting of those grades for failure to pay tuition. Thus, it is very important for the school to establish a policy on permission to complete course work when tuition is unpaid.

In summary, we recommend that the board of trustees establish a comprehensive policy regarding tuition billing and collection procedures, including sanctions to be applied in cases of nonpayment. Once the policy is established, there should be absolutely no exceptions to it without formal approval by the board.

B. Cash Disbursement Policies and Procedures

It is desirable for the business office to have a formal policy for the issuance of checks. The policy should cover the following points.

Persons authorized to sign checks. It is desirable to have several people authorized to sign checks so that someone will always be available when a check must go out. Normally, the head, the business manager, the treasurer, and the assistant treasurer are authorized.

Scheduled payment dates. It is usually most efficient to write checks only two or three times a month (such as the 5th, 15th, and 25th) rather than on a day-to-day basis. In any event, bills should not be paid before they are due because this wastes cash that can otherwise be invested and earn a return for the school.

Purchase discounts. Whenever discounts are offered for prompt payment, the school should not fail to take advantage of them. The cost of missing purchase discounts is usually very high. For example, a 2 per cent discount for payment within 10 days on a normal 30-day invoice is equivalent to a 36 per cent interest charge if it is not taken. If payment is not made by day 10, it must be made by day 30. The 2 per cent discount is thus offered in exchange for 20 days' use of the money. A 2 per cent charge for a 20-day period is equal to 36 per cent for the year. It is therefore strongly desirable always to take purchase discounts, even if money must be borrowed temporarily from a bank.

Timing of discretionary cash outflows. Cash payments that offer flexibility in timing should be scheduled in conjunction with the overall "cash flow" position. Normally, this means postponing payments at times when cash is particularly tight or when short-term borrowing is being used. If the school pays its bills promptly most of the time, vendors and suppliers are usually willing to extend payment terms during those periods of the year when the school's cash position is most critical.

C. Investing Excess Cash

If the business office is successful in collecting tuition promptly and is conservative in disbursing cash, there will be times during the year when the cash balance is temporarily larger than necessary to support the operations of the school. During such periods, excess cash should be withdrawn from the checking account and invested.

A recent money management survey conducted by NAIS indicated that 82 per cent of the 400 schools responding did have excess short-term cash funds at some time during the school year, ranging from \$15,000 to

\$2,000,000. The period over which all or part of these funds could be invested ranged from one or two months to nine or ten months, depending on the schools' cash collection and disbursement patterns.

In periods when short-term interest rates range from 6 to 8 per cent, some independent schools with an effective cash management program could earn interest income equal to 2 or 3 per cent of tuition income each year. For a school having \$1,000,000 of tuition billings, this could mean \$20,000 of interest income, which is equivalent to the cost of at least one experienced teacher.

Although there are many options available for investing temporary excess cash funds, the school should always choose those carrying a very low risk. Because the funds are only temporarily available and will be needed for operations later in the year, trading off a higher degree of risk for a possible higher return is not consistent with prudent financial management.

The easiest low-risk investment option to administer is a savings account. It is important to use a savings account that offers interest from the day of deposit to the day of withdrawal. If the funds can be committed for a definite period of time, say, 60 to 90 days or longer, certificates of deposit usually offer a slightly higher return than a savings account. U.S. government treasury bills and "prime" or "A" rated commercial paper issued by major corporations also represent low-risk investment opportunities. While a somewhat higher return can usually be earned in these debt instruments, larger amounts of money must be committed. Furthermore, there are extra administrative problems connected with buying and selling such securities.

Investment management firms operate many kinds of cash management

funds or "daily income funds." These funds, which invest cash left on deposit with them in a wide variety of money market instruments, offer daily deposit and withdrawal service and daily compounding of interest. Some of these funds allow the depositor to write checks against the balance, thus guaranteeing immediate liquidity, if required. Basically, the school's use of a cash management fund represents a decision that professional investment managers can earn a better average return on the school's excess cash than the business manager or the finance committee of the board can, even after allowing for the management fees involved. The school's banker should be able to recommend a good daily income fund, if this option seems attractive to the trustees.

The board of trustees should review and approve the choice of an investment option for temporary excess cash. For most independent schools, a savings account is an attractive choice when a balance among convenience, administrative ease, and earned return is being sought.

III. Short-Term Borrowing - The Line of Credit

Even when cash is managed effectively, there may be times during the year when the cash balance is temporarily negative or "in the red." This happens often in independent schools and is not necessarily a sign of poor financial health. It is simply a reflection of month-to-month imbalance in cash inflows and outflows. Such imbalances may recur temporarily even when particular attention is given to managing the cash flow.

When the cash balance starts to become negative, the school has to borrow funds temporarily until cash receipts again exceed disbursements. In most cases, the funds temporarily required are borrowed from the

school's commercial bank. We strongly recommend that such borrowing be planned well in advance and covered by a formal line of credit agreement.

The careful construction of a 12-month cash budget should ensure that the school knows when it will need to borrow, how much it will need, and when it can repay the loan. Bankers are much happier dealing with loan requests on this basis than they are with scattered requests triggered by a sudden overdraft situation in which the customer isn't sure how large a loan he will need or for how long.

A line of credit is an arrangement between a bank and a borrower (the school) specifying that loans up to a set maximum can be drawn down automatically by the borrower whenever needed. As loans are repaid, the unused credit line is again available for borrowing. Sometimes banks charge a commitment fee for the right to have a line of credit, which might be 1/4 per cent of the maximum line per year. Most independent schools that have a line of credit are not charged a commitment fee.

If a credit line is used, a desirable feature is daily unrestricted drawdown and repayment, with interest charged only on funds actually used. Some banks still require that transactions be recorded in 30-, 60-, or 90-day increments, with separate notes for each borrowing. This practice should be avoided, if possible.

Another requirement imposed by some banks in connection with a line of credit is that the customer maintain average checking account balances equal to 15 or 20 per cent of the credit line agreement or the average borrowings under the credit line. This "compensating balance" method is a way of increasing the effective interest rate earned by the lender. For example, if cash balances must equal 20 per cent of borrowed funds, the customer may only use 80 per cent, or 4/5, of the borrowings. If

8 per cent interest is charged on loans, the effective interest rate is really $8 \text{ per cent} \times \frac{5}{4}$, or 10 per cent. Since compensating balances are a form of interest surcharge, it is usually possible to negotiate a credit line without such a requirement when a "fair" interest rate is charged.

In order to know what the true cost of a line of credit is, the school should be aware of compensating balances, commitment fees, and restrictions on when funds may be repaid. It is desirable to consider more than one source in negotiating a credit line, for effective rates of interest and levels of service differ from bank to bank. Also, most banks' rates are negotiable. The trustees should assure themselves that the school is making as advantageous an arrangement as possible.

IV. Monitoring Daily Cash Balances

As a way of monitoring the cash position of the school on a day-to-day basis when cash receipts and disbursements records are summarized only monthly, many schools keep a daily cash recapitulation record. Such a record simply shows, for each day, cash deposited in the bank, the total amount of checks written, and the new cash balance carried over to the next day. We recommend keeping an informal record of this kind because it is very valuable in planning cash disbursements and monitoring excess funds available for investment.

V. Managing Petty Cash Funds

We recommend that the school use an "imprest" system for managing petty cash funds. Under an imprest system, a set amount of money is designated as a petty cash fund. As expenses are paid out of the fund, voucher slips signed by the recipient are maintained, showing the amount

and nature of the expenditure. At any given time, the sum of cash on hand plus signed voucher slips must equal the imprest balance for the fund. The fund can thus be audited as an internal control check at any time. When the cash balance falls to a certain level, the petty cash fund is reimbursed up to its imprest balance. The petty cash vouchers are reviewed in conjunction with the reimbursement to make sure that all expenditures have been appropriate. The vouchers are then canceled or marked "paid" to avoid the possibility of reuse. A sample petty cash voucher is shown on page 118.

An Illustration

Preparing a Monthly Cash Budget: XYZ School

The projected operating budget for XYZ School for the year ended June 30, 1976, is shown in Exhibit 9-2. One factor to consider in building the cash budget is XYZ's policy on annual giving. All cash received as gifts each year is immediately deposited in the regular checking account. It is considered as unrestricted funds to be used at the school's discretion to finance operations where necessary. At the end of the year, any surplus from operations is transferred to the quasi-endowment fund. Should a deficit occur, money is withdrawn from the quasi-endowment fund to offset it. Thus, the bank account for operating cash always shows \$5,000 as of July 1. This amount is the carry-over, residual balance in the account.

For the past year and a half, a new classroom building has been under construction. The total cost of \$651,000 is being financed through a major giving campaign, which has been fairly successful to date. More than 80 per cent of the needed money has been accumulated (mostly from one major benefactor). There is some doubt, according to the business manager, as to whether the remaining \$110,000 can be raised by the scheduled completion date of June 15, 1976. The budget anticipated receiving \$85,000, leaving a net deficit of \$25,000. The \$85,000 is expected to be received in March, which could present a problem in making the final payment to the contractor. The school has been paying the contractor \$15,000 a month for the 18 months he has already been working and will continue this for 12 more months, through completion, at which time a balance of \$201,000 will be due. Assuming that \$85,000 is

received, the school will be \$25,000 short for the final payment. The business manager plans to pay the \$25,000 from the operating account, borrow the amount needed, and try to repay the debt next year. Since the board of trustees does not want to use quasi-endowment fund money for nonoperating expenditures, that opportunity is closed.

Tuition payments come in at two distinct times during the year. Half the annual tuition charge is due within 30 days after September 15, and half within 30 days after February 15. Experience shows that about half of the amount billed is received by the end of September and February, respectively, and the remainder by the end of October and March.

The school rents its gymnasium and auditorium during the December and March recesses for use in local sports tournaments and for speaker programs. Each recess lasts nine days, and the school charges an all-inclusive fee of \$1,000 a day.

Interest and dividend income from the school's quasi-endowment fund is available to meet operating expenses. The firm managing this fund makes equal quarterly payments to the school beginning in January. An application fee of \$50 is required for each of the approximately 80 applications XYZ receives each year. The application deadline is May 30; half the applications come during April, half during May. Unrestricted giving in response to an annual February 1 mailing has historically been very generous. About three quarters of the money typically comes in during February and the rest during March.

The school maintains a large inventory of athletic equipment for use in all sports and also always has many books and school-supply items in inventory. Materials, supplies, library books, and athletic equipment are all ordered in June and paid for in August upon arrival of the merchandise.

Faculty members and other employees are paid over nine months (September through May).^{*} Food bills are paid monthly during the school's operating year, which runs from September through May. Payroll taxes are paid monthly. Utility bills are received bimonthly and paid within 10 days. The first two-month bill usually arrives around August 10. Insurance payments are due in two equal installments on September 15 and January 1.

The student yearbook costs in excess of sales and advertising are paid by the school in May after all sales have been made. Communications and information expenses and general and administrative expenses are incurred ratably over the calendar year.

Using this information, Exhibit 9-3 illustrates the projected monthly cash budget for the year ended June 30, 1976. As shown in this exhibit, the school would need to borrow money in July and August for two months, in December and January for two months, and again in June to cover the year-end payment of \$25,000 to the contractor. Operations for the year are projected to generate a \$5,000 surplus, leaving a \$15,000 year-end cash deficit. It is also possible that some of the inflows and outflows could be moved up or back to improve the over-all cash flow situation.

The point of this example is not to illustrate either effective or ineffective cash management, but rather to illustrate the mechanics of preparing a monthly cash budget. As noted earlier, such a budget is the basic tool of cash management.

^{*} Paying salaries over a nine-month period is not recommended practice. The use of this practice in this illustration does not imply that it is recommended. In fact, NAIS recommends that all salaries be paid over a twelve-month period.

Exhibit 9-2

XYZ School
Summary of Projected Revenues and Expenses
Year ended June 30, 1976

Revenues

Tuition and fees		\$512,000
Dividends and interest		16,000
Rentals received		18,000
Application fees		4,000
Annual giving (unrestricted)		<u>20,000*</u>
Total		<u>\$570,000</u>

Expenses

Salaries and wages	-	faculty	\$182,000	
		administration	60,000	
		other	<u>65,000</u>	307,000
Payroll taxes				48,000
Materials and supplies	-	educational	18,000	
		library	2,000	
		administrative	13,000	
		food	<u>43,000</u>	76,000
Utilities				25,000
Repairs and maintenance				28,000
Athletic equipment				2,000
Communications and information expenses				21,000
Insurance				18,000
General and administrative expenses				19,000
Yearbook				2,000
Financial aid				<u>19,000</u>
Total				<u>\$565,000</u>

<u>Projected surplus</u>	<u>\$ 5,000</u>
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*Not included: \$85,000 planned giving for the building fund.

Exhibit 9-3

XYZ School Cash Budget
 Year ended June 30, 1976
 (000 omitted)

	<u>Jul</u>	<u>Aug</u>	<u>Sep</u>	<u>Oct</u>	<u>Nov</u>	<u>Dec</u>	<u>Jan</u>	<u>Feb</u>	<u>Mar</u>	<u>Apr</u>	<u>May</u>	<u>Jun</u>	<u>Totals</u>
1. <u>Cash receipts</u>													
Tuition and fees (net)			123	124				123	123				493
Dividends and interest	4			4			4			4			16
Rentals received						9			9				18
Application fees										2	2		4
Annual giving	—	—	—	—	—	—	—	15	5	—	—	—	20
Total	4		123	128		9	4	138	137	6	2		551
2. <u>Cash disbursements</u>													
Salaries and wages			34	34	34	34	34	34	34	34	35		307
Payroll taxes	4	4	4	4	4	4	4	4	4	4	4	4	48
Books, materials and supplies and equipment		35											35
Food			5	5	5	5	4	5	5	5	4		43
Utilities		4		4		5		4		4		4	25
Repairs and maintenance	4	4	2	2	2	2	2	2	2	2	2	2	28
Insurance			9				9						18
General and administrative, Communications and informa- tion	3	3	4	3	3	4	3	3	4	3	3	4	40
Yearbook											2		2
Building fund*	—	—	—	—	—	—	—	—	—	—	—	25	25
Total	11	50	58	52	48	54	56	52	49	52	50	39	571
3. <u>Net change</u>	(7)	(50)	65	76	(48)	(45)	(52)	86	88	(46)	(48)	(39)	(20)
4. <u>Beginning balance</u>	5	(2)	(52)	13	89	41	(4)	(56)	30	118	72	24	5
5. <u>Ending balance</u>	(2)	(52)	13	89	41	(4)	(56)	30	118	72	24	(15)	(15)

Item 1 - item 2 = item 3.

Item 3 + item 4 = item 5.

Item 5 for one month becomes item 4 for the next month.

*The cash flow of the building fund account is not shown on this schedule. Only the \$25,000 payment from the operating account to close out the building fund is shown.

Chapter 10

FINANCIAL PLANNING

Planning is integral to the management of any organization. All managers must necessarily consider the future implications of their current actions and must also evaluate possible future alternatives. When a multi-year time span is adopted and the financial aspects of such planning activities are emphasized as a major organizing theme, the result is called "financial planning." The subject of this chapter is formal financial planning, in which the process is made an explicit, required aspect of the management of the school.

Twenty years ago, few independent schools or commercial enterprises engaged in formal financial planning. Most financial planning was informal, irregular, ad hoc, or implicit. Today, most major commercial enterprises engage in formal financial planning, but it is still quite unusual among independent schools.

The reasons for formal financial planning among business firms are just as applicable to independent schools.

Many aspects of school operations cannot be seen as variable when only looking forward one year at a time. Examples include the profile of the faculty or student body, the basic organization of the administrative staff, or the direction of the curriculum. It is necessary to look forward far enough so that these factors are not immutable "givens" if the school really wants to consider the implications of changing them.

Often what appears to be the most rational or "best" course of action in dealing with some problem is different when considering its implications three to five years from now. For example, replacing a retiring English teacher with another English teacher might not seem so logical if course

registration trends indicate a significant reduction in the English department's course load over the next few years. Formal planning facilitates careful consideration of the future implications of those decisions that need to be made today.

Many small, day-to-day decisions are made each year by school administrators without much careful "intellectualization" and without much formal analysis. Even though such decisions do not mean a great deal, individually, to the school as a whole, their cumulative impact over time can be significant. Many organizations have found that the exercise of formal financial planning creates a much more highly future-oriented mind set among the senior administrators, which translates into better "reflex decision-making" from day to day. This same phenomenon should apply to independent schools.

As Abraham Lincoln once noted, "If we could first know where we are and whither we are tending, we could better judge what to do and how to do it." All independent schools should begin formal financial planning. The remainder of this chapter is devoted to how this can be accomplished.

I. Decomposing the Cost Structure for Planning Purposes

It is useful to break the budget down into four major categories for planning purposes. Such a breakdown is useful because the method of analysis and frame of reference are different in tackling each of these four segments. The suggested categories are as follows.

Instructional expenditures: All expenses classified as "instruction" in Chapter 2.

Administrative expenditures: All expenses classified as "general and administrative" in Chapter 2.

Plant-related expenditures: All expenses included under "operation and maintenance of plant" in Chapter 2.

Auxiliary services: All expenses classified by the same caption in Chapter 2.

A. Instructional Expenditures

The cost of the instructional program is the result of the interaction of the following factors.

Student enrollment

Student workload: How many courses does a student take, and how many hours per week do these courses meet?

Course offerings: How many separate courses and multiple sections does the school offer?

Faculty workload: How many courses does a teacher teach, and how many hours a week do these courses meet?

Size of the faculty

Average class size (and variability around the average)

Faculty salary levels

Employee benefits package for faculty members

The first step in making a financial plan for the school is to consider specifically where it stands now on each of these "cost-causing" factors. Each of them represents a variable that can be changed if the school decides to do so. None of them is immutable. Furthermore, the range of current practices among independent schools varies significantly on all of them. For example, benefits for faculty members normally include FICA and some form of supplemental retirement benefits, such as TIAA/CREF, plus hospital and medical insurance. They can also include dental insurance, group life insurance, disability insurance, and full or partial tuition remission. Excluding the value of live-in perquisites,

such as food, housing, and use of an infirmary, the employee benefits package among independent schools ranges from 10 per cent of cash salaries to over 25 per cent.

The first six items in the above list should be analyzed at a departmental level in order to highlight differences among departments, which would be buried in overall school averages.

A specific, quantitative analysis of these various factors is beyond the scope of this book. However, each of them does play an important part in the cost structure of the school, and each one should be analyzed separately in determining why the school's instructional programs cost what they do.

B. Administrative Expenditures

The key to analyzing administrative expenses is a comprehensive organization chart for the school, showing how the various administrative functions of the school are grouped, who is responsible for them, how many support (clerical and secretarial) personnel are assigned to each, and how much each administrator and supporting staff person is paid. In an independent day school, the following functions must be covered by someone: admissions, business office, dean of faculty, dean of students, and development/alumni(ae) affairs. In a boarding school, residence halls and food service typically also require a full-time senior-level administrator.

NAIS publishes statistics based on information from member schools twice a year. The September edition contains tuition fees, faculty salaries, and administrative salaries for the current school year. In February, information based on the results of the prior year is given on

gift support, fund-raising costs, financial aid, minority students and teachers, and financial operations; information based on the current year gives data on NAIS membership, types of schools and enrollments, and enrollment trends. Special studies are made for individual schools, for a fee, based on the above information; the names and figures of the schools used in these studies are not made public.

C. Plant-Related Expenditures

A key factor in analyzing and controlling plant-related expenditures is the level of investment in plant assets. The level of investment per student varies dramatically among independent schools. The range, stated in terms of replacement value in current dollars, is from less than \$2,000 per student to over \$12,000 per student for day schools, and from less than \$10,000 per student to over \$60,000 per student for boarding schools. Since the annual cost for utilities, insurance, maintenance, janitorial services, and average renewal outlays seldom runs less than 6 to 8 per cent of plant value, this means a range of annual plant cost from around \$120 per student to over \$1,000 per student, just among day schools.

Unfortunately, comparative figures for maintenance and janitorial cost per square foot or per dollar of plant value, or utilities cost per square foot or per student, exist among very few independent schools. This is an area in which much progress needs to be made. The task is made significantly more complex because of high cost variability due to the range of climate conditions, different mixes of fuels used, differing types of plant construction, and varying ages of plant assets.

It is almost a truism that a school always "needs" more plant than

it has. Every school has a list of "necessary" additional plant assets that are waiting for available funding. While it is also true that not many independent schools have been driven to bankruptcy because of too much plant, the burden of carrying the plant each year does impinge much more heavily on some schools than on others. The level of investment in plant assets cannot be changed dramatically in the short run. However, careful attention to how much plant the school can really afford and to whether future plans should realistically involve plant expansion, contraction, or significant redeployment represents a major aspect of effective financial planning. To a large extent, the level, type, and age of plant assets determine the annual cost for operation and maintenance of plant.

Specific consideration of norms or guidelines for various plant-related cost items is beyond the scope of this book.

D. Auxiliary Services Expenditures

The key to analyzing auxiliary service expenses is to determine which services really need to be provided. Just because the school has always provided a hot lunch program and door-to-door busing does not mean that it necessarily must do so in the future. As for food services, there are many examples of successful day schools at each of the following levels of commitment.

Hot lunch served family-style in a dining room.

Hot lunch provided cafeteria-style in a lunchroom.

Food machines (and brownbag lunches), with a lunchroom provided.

Lunch room available, but only beverage machines provided.

Lunchroom provided, with no vending equipment or support personnel.

Students eat brownbag lunches in their classrooms.

Students go home for lunch.

The costs of these options obviously vary tremendously. A similar set of options exists for transportation of students in a day school. In a boarding school, widely varying levels of commitment are possible for the infirmary, the laundry, and the student store.

The main point here is that cost analysis for auxiliary services begins with an analysis of the appropriateness of the level of each service being provided. Assuming that this level of service is being offered in the most cost-effective way, can the school afford to do it? Alternatively, from a policy point of view, can the school afford not to do it? Once this basic issue is resolved for the time period being studied, good comparative data exist for what it should cost, per student, to provide that level of service. Evaluating the cost effectiveness at the level of service deemed appropriate is an important but less troublesome planning problem.

E. Overview

This discussion of the four principal components of the operating budget has focused on analyzing major factors affecting the current level of expenditures. Such an analysis of why the school is spending what it does is the first phase of comprehensive financial planning for the school. This phase involves three distinct steps.

Analyze current spending levels.

Compare with past trends and/or with similar schools.

Evaluate specific strengths and weaknesses.

II. The Financial Planning Process - An Overview

Here we outline, in sequence, the various phases of putting together a financial plan for the school.

1. Analyze the current cost situation. For each of the major components of the operating budget, analyze the current primary "cost-causing factors" as described in section I, above.

2. Project the cost structure forward. Taking into consideration any specific changes that are deemed appropriate in the various "cost-causing factors," as well as projected inflation rates and unavoidable cost changes, project the cost structure forward over the time span selected for the financial plan. When these projections are pulled together for all four major components of the budget, the result is a preliminary comprehensive year-by-year expenditure plan.

3. Project other income. Using the same time span, project expected nontuition revenues--gifts, dividends and interest, student fees, and miscellaneous income.

4. Compare phases 2 and 3. The difference between projected cost outlays and projected nontuition revenues each year is the amount required to be raised through tuition. When divided by enrollment figures, this becomes the preliminary planned tuition figure per student. Of course, different tuition rates may be projected at different grade levels or for boarding versus day students, if both are present.

5. Evaluate phase 4. Are the projected tuition rates or sets of rates from phase 4 "reasonable" or "acceptable" to the trustees? If so, the planning process can be considered complete and attention can turn to implementing the plan.

6. Recycle, if necessary. If the projected tuition rates at phase 4

are not considered "acceptable," the planning process must revert to phase 2 and cycle through again until an acceptable result is derived at phase 5.

In actuality, things never go along this neatly and cleanly in sequence. However, the proposed approach does represent what we consider to be a workable summary of what needs to be done and where the process starts and stops.

III. Formal Financial Planning - Some Other Issues

A. What Is an Appropriate Time Span over Which To Plan?

Clearly, one year is too short a time span, and 10 years is quite probably too long. The key is to balance the loss of realism and confidence of a long time span against the overly restricted set of variables of a short time span. Five years is a time span commonly used by many businesses. We recommend that the time span be at least three years. Five years is probably as long a time span as should be considered in getting a planning process started in an independent school.

B. How Often Should the Process Be Repeated?

It is very important to realize that a financial plan is not something cast in concrete or something shelved until the three, four, or five years in the plan have passed. The plan is a living thing that needs to be re-evaluated continuously as the environment in which it was created changes.

Of course, it is not feasible to rework the plan weekly or even monthly. We do, however, recommend that the planning process be repeated every year. Then, one new year is added to the plan as the current year drops out. In redoing the plan each year, it may also be necessary to

change the projections for the intermediate years as well as adding a new year.

Changing the accepted figures for the intermediate years can conceivably hurt the credibility of the planning exercise. This problem needs to be handled carefully. However, if the environment changes from year to year, this problem is less serious than trying to make an old plan come true in an environment that is no longer optimal.

C. Who Gets Involved in the Planning Process?

The plan is not something the head can do alone or only with the business manager. As with the one-year budgeting process discussed in Chapter 9, many members of the school community need to be involved in the planning process. Since the plan represents the coordination of the school's educational mission and its financial resources, it is imperative that all segments of the community be involved and that they be committed to the courses of action implied by the plan.

D. Are Planning Documents Desirable?

In planning for the future, the school would do well to prepare formal financial planning documents for study and revision each year. Such documents alert the school's key financial managers to current trends and give those responsible for the financial well-being of the school a clear blueprint or profile of the financial makeup of the school.

E. How Can Inflation Best Be Handled?

While it is true that future rates of inflation are extremely difficult to predict and that inflation represents a major uncertainty for schools, it is not impossible to make meaningful plans. First of

all, inflation rates are more easily projected over three years than over 10 years. Second, schools are "protected" from inflation to a large extent, for if inflation runs higher than predicted, parents' income will probably also run higher than predicted. Changes in the largest cost factor for schools--salaries--can be related fairly directly to changes in the level of parent family salaries. This means that proportionate tuition adjustments are usually not too difficult to implement.

In making a financial plan, serious attention should be paid to forecasting inflation rates as accurately as possible. However, errors in this forecast are largely self-compensating, so the problem is not normally a crucial one.